UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNITED NATIONS

CENTER FOR
INTERNATIONAL
DEVELOPMENT
HARVARD UNIVERSITY

G-24 Discussion Paper Series

The Indonesian Bank Crisis and Restructuring: Lessons and Implications for other Developing Countries

Mari Pangestu

No. 23, November 2003

UNITED NATIONS CONFERENCE ON
TRADE AND DEVELOPMENT

CENTER FOR INTERNATIONAL DEVELOPMENT
HARVARD UNIVERSITY

G-24 Discussion Paper Series

Research papers for the Intergovernmental Group of Twenty-Four on International Monetary Affairs

UNITED NATIONS
New York and Geneva, November 2003

Note

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

*

*   *

The views expressed in this Series are those of the authors and do not necessarily reflect the views of the UNCTAD secretariat. The designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

*

*   *

Material in this publication may be freely quoted; acknowledgement, however, is requested (including reference to the document number). It would be appreciated if a copy of the publication containing the quotation were sent to the Publications Assistant, Macroeconomic and Development Policies Branch, Division on Globalization and Development Strategies, UNCTAD, Palais des Nations, CH-1211 Geneva 10.

UNITED NATIONS PUBLICATION

UNCTAD/GDS/MDPB/G24/2003/4

THE INDONESIAN BANK CRISIS AND RESTRUCTURING: LESSONS AND IMPLICATIONS FOR OTHER DEVELOPING COUNTRIES

Mari Pangestu

Centre for Strategic and International Studies, Jakarta

G-24 Discussion Paper No. 23

November 2003

PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Government of Denmark, as well as contributions from the countries participating in the meetings of the G-24.

Abstract

Drawing on the Indonesian experience in 1997, this paper demonstrates the complexity of managing banking crises deals. It aims at deriving conclusions from this experience for other developing countries facing similar problems. The paper also refers to comparative experiences of other countries, in particular Malaysia and Thailand, examines the IMF programme and reveals its shortcomings.

The key question is to what extent the ineffectiveness and slow progress of bank restructuring, corporate restructuring and continued dilemmas in macroeconomic management in Indonesia were due to shortcomings of the economic programme, its sequencing or emphasis, and to what extent it has to be attributed other factors, including corruption and lack of policy-making capacity.

Although prudential requirements and regulations, such as lending limits, were introduced to address corporate governance problems, governance of the banking sector was generally weak, and there was little incentive for banks to make appropriate risk assessments in their activities. It is shown that structural weaknesses precipitated and aggravated the crisis.

There is clear evidence for mistakes in the initial responses to the crisis by both the Government and the international financial institutions. The most difficult problems facing a country like Indonesia are the political and social constraints to rapid restructuring and reforms to strengthen the financial sector.

Indonesia was obliged to implement second generation Washington consensus reforms focusing on corporate governance, bankruptcy procedures, business-government relations, and more restrictive prudential regulation. A clear message of the paper is that a "one-size-fits-all" programme is unlikely to be successful. Policy makers must be able to address linkages between the financial sector and macroeconomic performance, which, if not managed appropriately, can exacerbate macroeconomic cycles. There is also a need to reduce the concentration of bank ownership and to minimize moral hazards through the design of clear exit mechanisms. Moreover, attempts to restructure the banking system can only be successful in the context of an overall recovery of the domestic economy.

The main message of the paper is the importance of appropriate speed and sequencing of necessary reforms, taking due account of the institutional, legal and human capacities that are specific to each country.

Table of contents

THE INDONESIAN BANK CRISIS AND RESTRUCTURING: LESSONS AND IMPLICATIONS FOR OTHER DEVELOPING COUNTRIES

Mari Pangestu

I. Introduction

The causes of the Asian crisis have been widely analyzed to date and as the story unfolded, the assessments and consensus with regard to the appropriateness of responses and longer-term restructuring issues have also changed. The various IMF programmes that the crisis countries such as Indonesia have undergone have also evolved, and the IMF itself has undergone introspection with regard to the appropriateness of IMF conditionalities. It would be true to say that we are all still in the process of understanding and learning. A consensus has yet to emerge on how to balance the dilemma between the conditions set to access IMF and other donor funds, and the implementability of the programme from the perspective of the country in question. Assessing the latter involves a range of issues such as appropriateness of the responses, ownership of the programme, and the acceptable degree of flexibility given institutional and political constraints. Current experience, whether it be in Indonesia or in Russia, Turkey and Argentina, clearly indicates that required actions and conditionalities cannot be determined without consideration of governance problems, pressure from vested interests, political pressures, weaknesses of institutions and of the legal infrastructure.

This paper takes the experience of the Indonesian economic crisis, and the management thereof through the various IMF programmes, as a case study to demonstrate the complexity of the dilemma, the lessons we have learned to date, and the potential measures that could be taken. To make the analysis more focused, we will concentrate particularly on the banking crisis, on restructuring and on the current process of recovery as experienced by Indonesia. Given the intertwining of the banking, corporate and macro stories, one must also touch on these aspects. References to comparative experience of other crisis countries, particularly in Malaysia and Thailand, will be made.

This paper begins by reviewing the consensus and debate, and changes thereof, that have emerged to date on the causes of the crisis and the vulnerabilities of the fundamental structure of these economies which have led to a longer and deeper crisis than would otherwise have been the case. The debate has evolved, and as a result thinking on the remedies to be undertaken to respond to the crisis, to restructure, and to initiate recovery and to finally introduce elements to prevent future crisis have also evolved. Mistakes were made and lessons learned, with fiscal ramifications, which will be long felt. Indonesia was chosen as the case study due to the author's familiarity with the country and also because it was the worst-hit country, and one which continues to struggle with its bank restructuring programme.

The second section focuses on the lessons learned in managing banking crisis and the subsequent process of rehabilitation and recapitalization. Attention will be drawn particularly on the question of how realistic it was to have expected countries like Indonesia with the institutional, legal and political constraints – as well as struggling with the setting up of democratic institutions in a newly found democracy – to meet second generation Washington consensus and international standards (including those of the Bank for International Settlement (BIS)) of transparency and corporate governance. The key question is how much is the ineffectiveness and slow progress of bank restructuring, corporate restructuring and continued dilemmas in macro economic policy management in Indonesia a factor of the wrong programme, the wrong sequence or emphasis and how much is due to politics, corruption and incapacity of policy makers?

The third section assesses the way forward and the interim steps that a country like Indonesia needs to take. A number of suggested approaches have emerged and basically there is now recognition of the need for intermediate steps prior to the longer-term goals of bank prudential regulations and standards which approach that of developed countries. The issue of applicability to the Indonesian case will be examined.

The main message of the paper is the importance of sequencing and pacing necessary reforms by bearing in mind the dilemma between what is ideally desirable, and what is doable. It is also important to design interim steps to get more ownership and gain domestic support for the reform programme and institutional and behavioural changes, to ensure that the longer-term goals will be upheld.

II. Structural vulnerabilities in banking sector pre-crisis

A. Build up of vulnerabilities pre-crisis

Three major sets of factors contributed to the build up of vulnerabilities in the banking sector pre-crisis. The first of these was the rapid expansion of the banking sector after the comprehensive reforms in 1988 that was not accompanied by adequate prudential regulations and central bank supervision. Second was the weak corporate governance in the banking sector due to high concentration of ownership. Third were the effects of the economic boom and international financial integration, which amplified the vulnerabilities.

1. Liberalization and lack of a sound banking system

Indonesia’s financial sector liberalization was undertaken in two stages, with the lifting of interest rate and credit ceilings, and reduction of liquidity credits to state banks in 1983, followed by comprehensive liberalization in October 1988 whereby most of the entry barriers and various restrictions that favoured certain types of banks were removed. There was open entry for new domestic and joint venture banks, relaxation of branching requirements for both domestic and joint venture banks, reduction of the reserve requirement ratios, and state owned companies were allowed to deposit up to 50 per cent of their deposits in non-state banks.

Within a few years of the reforms there was a dramatic increase in the number of banks and branches, M2 growth, and credit. The number of new banks increased from 61 in 1988 to 119 in 1991 and the number of foreign banks increased from 11 to 29. The number of branches of private domestic banks quadrupled from just 559 in 1988 to 2,639 by the end of 1991. The asset quality problem and low capital levels hindered the growth of state banks, whilst the private banks expanded rapidly and began to overtake the state banks by 1994, in terms of loans, deposits (for which private banks were already ahead in 1992) and total assets. The Government attempted to strengthen the state banks by announcing plans for mergers and privatization, but only Bank Negara Indonesia, the largest of the state banks went public and no meaningful progress on mergers took place prior to the crisis.

Unfortunately the rapid expansion of the banking sector was not matched by prudential regulations and improved supervision by Bank Indonesia – the Indonesian Central Bank – to deal with the dramatic increase in the number of banks and branches. The rapid increase in liquidity, due to the reduction in reserve requirements and growth of M2, led to overheating pressures and rising inflation in the early 1990s. The monetary authorities responded by tightening monetary policy, and, faced with growing criticism and caution over the rapid expansion of

Table 1

COMPARATIVE INITIAL CONDITIONS: INDONESIA, MALAYSIA AND THAILAND

	Indonesia	*Malaysia*	*Thailand*
Foreign liability banks / total liability (1997)	15%	7.4%	27.4%
Capital adequacy	8 % target 87 % complied	8 % target Actual 11.4 % average	8.5 % target Actual 9.8 % average
NPL / total loans (end 1997)	7.2%	5.9%	22.6%
Corporate debt (1998)	$118 billion	$120 billion	$195.7 billion
External	$67.1 billion	$40 billion	$32.5 billion
Domestic	$50.9 billion	$80.2 billion	$163.2 billion
Debt equity (1996)	200%	140%	240%
Major financial institutions: (early 1997)	238 banks incl. 10 foreign	48 banks incl. 13 foreign and 39 finance co.	29 banks incl. 14 foreign and 91 finance co.
Deposit insurance	None until explicitly unlim. in August 1997	None	None until January 1998
Bankruptcy law	Outdated, 1998	Modern	Outdated, 1940

Source: Adapted from table 1, Kawai (2001).

the banking sector, introduced improved prudential regulations of the banking system in February 1991, two years after the comprehensive liberalization of the banking sector.

The prudential regulations introduced included a comprehensive capital, asset, management, equity and liquidity (CAMEL) quantitative rating system. The system included requirements for stricter qualifications of bank owners and managers; a schedule to meet capital adequacy requirements (CAR) according to the BIS standard of 8 per cent on risk weighted assets by 1993, stricter information and reporting requirements and stricter legal lending limit regulations to related groups or to one individual group. A new banking law was passed in 1992 with strict sanctions for bank owners, managers and commissioners for the violation of laws and regulations related to managing the banks. Foreigners were also now allowed to purchase bank shares in the capital markets and the legal status of the state banks was changed to a limited liability company, to allow them more autonomy and be managed as a private corporation. In October 1992, as part of the desire to limit the number of banks, the capital requirements to set up domestic and joint venture banks were raised by five times for the former and by double for the latter.

Despite these regulations and regular updates and improvements in the prudential regulations, there were still weaknesses in the legal and regulatory framework especially with regard to loan classification. An even more serious problem was the lack of enforcement of these prudential regulations due to a combination of weak capacity and capability of bank supervisors in the Central Bank, corruption and political interference of favoured owners close to the centre of power. As a result violations of the prudential regulations were not properly sanctioned and non-compliance was widespread as became evident in the audits of the banks undertaken after the crisis.

In comparison (table 1) Malaysia already experienced a banking crisis in the mid-1980s, and a substantial reform programme which were introduced after then led to recovery in the late 1980s. This experience contributed to Malaysia having better institutional and regulatory structure, as compared with Indonesia or Thailand. Malaysia also differed from these two countries by having relatively stronger regulatory structure and legal framework for corporate sector problem resolution even prior to the crisis. For instance, Malaysia already had modern bankruptcy laws, regulations and procedures.

Although Malaysia did not embark on a rapid liberalization of the financial sector as did Indonesia, and had a better legal and institutional infrastructure, Malaysia remained nevertheless vulnerable to the crisis due to a number of reasons (Thillainathan, 2001). During the period 1990–1997 there was rapid expansion of credit at around 30 per cent per annum, overexposure of the banking system to the volatile market for shares and property (estimated at over 40 per cent of the portfolio), weak management caused by continued restrictions on hiring and compensation, weak supervision due to capacity and hiring constraints as well as failure of the Government to raise the banking standards closer to international best practices and align incentives of owners, managers, depositors, and regulators to prudent banking.

The failure to meet international standards has to do with not imposing the required rigorous standards on loan classifications and provisioning and financial disclosure. The increasing role of banking groups in underwriting and brokerage business in the 1990s has also been a source of concern as these institutions are exposed to both credit and market risks. The requirement for risk capital for these institutions was also low.

In Thailand, the banks were related to business groups since trade financiers, who later expanded to become industrialists, started into banks and eventually these bank-centred groups became the large industrial conglomerates whereby insider lending had become a problem, just as in the case of Indonesia. The lack of proper evaluation of loans, even to third parties, was a major problem in the Thai banking system. This lack of evaluation and monitoring was resolved by demanding collateral in the form of land, or property, as well as personal guarantees from limited liability companies. In comparison, the foreign commercial banks operating in Thailand had to adhere to international standards and principles advocated by headquarters and thus their lending decisions were based on proper evaluation. The main vulnerabilities (Vichyanond, 2001) of the Thai banking system were the lack of systemic credit risk assessment; overexposure to credits given to affiliated businesses, shareholders and directors; and speculative lending with rapid growth and concentration in risky sectors such as real estate which were vulnerable to asset price changes. These results came about due to the lack of competition and of qualified and professional bank personnel. In Thailand, liberalization occurred by allowing entry of financial companies who were, in fact, under less stringent rules compared with banks.

The lesson is clearly that of poor sequencing with controls on bank liabilities being removed, such as interest rates, but with the oversight on the assets side and the skill and experience for assessing the level of risk, lagging behind. The vulnerabilities that this caused were severely underestimated by all – academic analysts, advisers, policy officials and international financial institutions. Even after the prudential regulations were introduced and capital adequacy standards met, information and data problems, inadequate loan loss provisioning and the quality of loan portfolios were still a problem. In addition to higher risk, the newly liberalized financial sector also had to contend with revolution in technology, communications and financial engineering (World Bank 2001: 90).

2. *Weak corporate governance, moral hazard and incentive structures*

Although prudential requirements and regulations were introduced to address corporate governance issues such as legal lending limits, there was overall weak banking sector governance and little incentive for banks to review their corporate lending carefully, or to behave in a risk appropriate way. There were several underlying reasons for this outcome.

First is that despite the increase in the number of banks after 1988, the banking sector remained highly concentrated amongst a few private and state banks. The top 10 private banks and the 6 state banks together accounted for 75 per cent of total bank assets. The number of private banks doubled to reach 164 after the 1988 bank liberalization, but concentration of the sector remained high, with the top 10 private banks in Indonesia accounting for 68 per cent of total private bank assets. However, concentration in itself was not the issue; rather, it was the lack of incentive for appropriate behaviour.

Second is concentration in majority ownership hands, both state and private sector, which resulted in asymmetry of information for all stakeholders. Although a number of the major private banks also issued shares in the capital market, the original owners were still holding the majority of shares, and information asymmetries (an incomplete and imperfect information system) prevailed between the majority shareholders and minority shareholders, investors and creditors. Moreover, even if information disclosure were required, the information given was not necessarily accurate due to weak accounting standards and auditing practices. There were also information asymmetry problems with bank supervisors, as well as the weak capacity of bank supervision by the Central Bank, including collusive practices and instances of interference.

Despite legal lending limits to affiliated groups or one group, there was gross violation of this requirement as became evident in the post audits being undertaken on banks taken over by the Government. The top 10 private banks were linked to major business as well as politically powerful groups. For instance, two of the largest private banks – Bank Central Asia (BCA) and Bank Umum Nasional (BUN) – have shareholders linked to former President Suharto. Another private bank, the Bank Duta, was known to hold the funds of the former President's foundations and of Badan Urusan Logistik Negara (BULOG), the state logistics agency. As for state banks, a number of the large banks, including BNI 1946 the largest state bank, did issue shares to the public. However, the state also still retained a large majority and was thus still able to exert great control over the bank. Other mechanisms to enforce good governance over owners and managers, such as central bank supervision and rating agencies were not effective due to a combination of lack of implementation, and information asymmetries.

In comparison, the Malaysian banking system is less concentrated and relationship based compared with other East Asian countries. The structure of the banking system is as follows: Foreign banks accounted for 20 per cent of the banking system; and government-owned or government-controlled banks account for another 30 per cent of the market share. The largest bank is government-owned and is publicly listed. The remaining banks are privately owned, often with private family interests. The leading local banks are mostly publicly listed, but still have a dominant shareholder in the form of a government institution or private family interest. However, the private commercial banks were mostly not part of a conglomerate. In the Malaysian experience, prohibition of loans to related parties and enforcement by the Central Bank of this rule appeared to have been able to reduce overexposure to large business group lending as had occurred in Indonesia. There was also no overt directed lending imposed by the Government on banks.

The weaknesses in the Malaysian banking system was to found elsewhere. The promotion and support of a number of mega projects by the Government, and lenders' assumption that the Government would not let these projects fail, led to lending by banks based on the collateral of the project as well as implicit government guarantees, and not necessarily on the viability and feasibility of the project. Thus overinvestment, lower returns, poor cash flows and emerging problem loans also occurred. Privatization deals which were not just purely market driven but which also aimed to fulfil the non-economic objectives of promoting indigenous or indigenous (*bumiputra*) entrepreneurs too have caused problematic privatization deals and exposing the stock market and banking industry with its overexposure to share financing, to vulnerabilities of the crisis (Thillainathan, 2001).

Third in the case of Indonesia, there was an implicit government guarantee to bail out banks and no clear exit policy. Only one bank had been allowed to fail in the 1990s and there were cases of government banks and private banks being bailed out as described in box 1.

In contrast, the regulatory and incentive system facing Malaysian banks was such that after the 1980s banking crisis, no banks, but with few exceptions would be rescued. However, the depositors were implicitly guaranteed thus still creating the problem of moral hazard. Thillainathan (2001) argues that this led to Malaysian banks having a higher gearing ratio and higher propensity for banks owners and managers to engage in risky lending than would otherwise have been the case without such full guarantee of depositors.

3. *Macro policy and financial integration*

The build up in Indonesia's vulnerability pre-crisis was associated with reinforcing dynamics between capital inflows, macro policies, and weak

Box 1

EXAMPLES OF TOO BIG OR TOO IMPORTANT TO FAIL

1. ***Bappindo***, the state owned development bank had been having problems for many years and in the late 1980s was discovered to have a large number of non-performing loans, including a case of serious corruption in order to obtain credit for large projects. Instead of closing down the bank or undertaking drastic restructuring efforts, the bank was allowed to continue to function and the sanctions to the corruption stopped at the officers level and one business man who actually "escaped" from prison.

2. Another case was ***Bank Duta*** which was a private domestic bank that experienced large foreign exchange losses due to currency speculation. At the time the Bank went public, in fact they were already suffering losses due to foreign exchange positioning, but the bank still went public with fraudulent financial statements. The bank held deposits of the State Logistics Agency and the foundations of President Suharto, and as such was "rescued" by "persuading" one of the business conglomerates to contribute to a bailout plan. The manager of the Treasury division was jailed and the management of the Bank changed.

3. ***Corporations:*** two corporations in cement (i.e. Indocement) and cold rolling mill which is the upstream of steel production (i.e. CRMI) which had a large stake of the Salim group was "rescued" by the government coming in as shareholders.

4. Cases of ***implicit government guarantees*** through providing captive market, special policy and directed lending (often involving state banks and/or central bank liquidity credits). One of the most blatant examples in recent times was the Timor National Car and the clove import monopoly, both linked to the former President Suharto's youngest son. Timor was given special status of being allowed to import their parts and components, and then later fully built up vehicles from Kia in Korea, duty free. The argument was that satisfaction of local content would be met within three years. Not only was it given this special duty free status, captive market was provided through government civil servants being given special preferences to purchase the vehicle and for police cars to Timor. Furthermore banks, including state banks, were asked to give loans to the venture. In the case of the clove monopoly, the private body was given monopoly to purchase the cloves from farmers and resell to cigarette manufacturers, and was provided low interest credit directly from the Central Bank. Later on it ran into many difficulties.

financial and corporate sector institutions (Ghosh and Pangestu, 1999). It should be noted at the outset that Indonesia has had an open capital account since the late 1960s.

In response to growing domestic pressures and capital inflows in the mid-1990s, Indonesia employed a macroeconomic policy mix that actually encouraged further capital. The policy mix was comprised of a dramatic tightening in the monetary policy stance;[1] fiscal policy which was not used in a counter cyclical way so that the burden of stabilization fell on monetary policy and led to high interest rates; and whilst the rupiah was under a managed float system, its depreciation was at a predictable 5 per cent per annum. The high cost of domestic of borrowing led to offshore borrowing by corporations which could do so, and banks often unhedged given the predictable depreciation. The monetary authorities attempted to curb expansion of liquidity through the banking system by placing offshore borrowing limits on banks, state related lending, and eventually non-bank financial institutions (NBFI). The three shocks – tight monetary stance, prudential regulations and offshore borrowing ceilings imposed in the early 1990s – had a major impact on the banking system. However, private corporations did not experience limits to offshore borrowing, and continued to borrow abroad without hedging, and to fund activities that were predominantly rupiah-based. The high domestic interest rates also led to an increase in deposits of non-residents or Indonesians repatriating their funds domestically, thus increasing capital inflows. In addition, in late-1995 the Central Bank banned commercial papers issuance by finance companies[2] which triggered a massive switch of their source of funding from on-shore to off-shore borrowings. In 1996 the Central Bank also required commercial paper traded by banks to be rated, effectively requiring companies issuing commercial paper to be rated.

Funds from offshore borrowing and capital inflows meant that domestic banks were flush with liquidity, and since there was heavy reliance on the banking sector[3] for financing, there was rapid expansion of credit. This credit was directed at increasingly unproductive and risky sectors such as property and consumer lending to purchase and speculate in property and stocks. Property lending increased from 6 per cent of GDP in 1993, to 16 per cent of GDP in 1996, and the amount of mortgage loans almost tripled during the same period from Rp6 to Rp16 trillion. The resulting asset price increases in the real estate and stock markets in turn progressively skewed investments towards these sectors, as banks increased lending, especially to the property sector based on inflated collateral prices. The property sector and other sectors such as infrastructure and some manufacturing sectors (e.g. automotive) experienced overinvestment and excess capacity.

Another important facet of the Indonesian banking system was the impact of increased financial integration due to the opening up of the banking sector in 1988, with respect to efficiency of the banking sector and risk appropriate behaviour of domestic banks. The presence of foreign banks is intended to facilitate transfer of technology in skill and products, through technical assistance or foreign bank personnel moving to the local banks. However, it is unclear that increased efficiency due to competition was achieved based on two indicators, bank net interest and operating margins, which did not show a definitive declining trend. Part of the reason for this outcome is that competition has increased the risk profile and overhead costs of domestic banks by crowding out of prime borrowers and the higher risk and costs of competing domestically.

Foreign banks largely focused on the corporate sector and within this segment have naturally focused their attention on home-based or existing multinational company customer base in Indonesia and the top-tier corporations, given their more conservative and strict credit risk profile, resulting in intense bank competition within this market segment. Furthermore, top-tier corporations, also largely with the help of foreign banks (investment and commercial banks) have been active in tapping the capital markets (both foreign and domestic) directly, either through the issuance of equity or debt (short-term CP and long-term bond) instruments. Stocks issued through the capital markets grew from Rp27.6 trillion as of end-1991 to Rp152.2 trillion by end-1995. For the same period bonds issued grew from Rp2.2 trillion to Rp5.3 trillion. The top-tier firms were obtaining lower cost of offshore funding due to high domestic interest, the risk premium charged were also declining due to learning as well as reputation. For instance top-tier corporations such as Astra observed their spread on Eurobonds narrowing from an average of 2.5–3.0 per cent in the late 1980s down to around 1.5–2.0 per cent in the 1990s.

Most of the domestic banks in Indonesia were still in the still in the “risky” development phase when the crisis hit. Domestic banks, trying to avoid competing head-on with the foreign banks, gradually shifted their strategic business focus on what they often called the middle market made up of second-tier corporations, small and medium businesses and individual consumers. Most of the top-tier private banks began to focus on the retail middle market as their major business in the mid-1990s. Given the availability of information and the transparency of issues, entry into this relatively new segment meant that banks faced higher risk and inevitably experienced larger non-performing loan levels (table 2).

Table 2

NON-PERFORMING PROPERTY LOANS, 1992–APRIL 1997

(NPL/total property loans: per cent)

Sub-sector	*1993*	*1994*	*1995*	*1996*	*April 1997*
Construction	13.49	13.25	11.62	9.58	9.62
Real estate	8.05	5.77	4.48	3.71	4.37
Mortgage	3.20	2.67	2.72	2.99	3.67
Total property	9.24	7.86	6.53	5.69	6.04
Total credit	n.a.	11.63	n.a.	8.79	9.23

Source: Bank Indonesia.

Reflecting this higher risk, interest spreads on retail-type loans are normally 2 to 3 percentage points higher than a corporate loan. Moreover, lending was based mainly on collateral value, whether it is business property, a house or a car. The collateral was often specific to ensure quick repossession and eventually sales in the secondary market. Banks also competed by geographical extension in the market resulting in rapid expansion of branch networks with increased overhead costs and venturing into new locations and smaller towns, which raised further the risk profile. Efforts to go public by a number of the private banks also led to large investments in technology and human resources, which kept net interest margins high and operating margins low.

Despite their higher risk profile, most domestic banks continued to have provision for bad debts less than their non-performing levels. This practice was not uncommon and was reinforced by Bank Indonesia allowing banks to deduct loan collateral value from the provisioning needs.

B. In sum: lessons learned from financial liberalization

The important lesson here is that financial liberalization should be done gradually and in a pace that takes into account the preparedness of the underlying institutions, legal and human capacity.

Demirguc-Kunt and Detragiache (1998) found a strong relationship between financial liberalization and financial fragility (53 developed and developing countries during 1980–1995 – liberalization observed policy change of deregulation of interest rates) after controlling for other variables such as macroeconomic variables, characteristics of the banking sector, and institutional variables. He found that stronger fragility occurs not immediately after liberalization but a few years after; and lack of institutions such as effective prudential regulation and supervision, well functioning capital markets, legal system. Bank franchise value falls after liberalization and there have been suggestions that increased moral hazard is linked to this lower franchise value and thus making banking crisis more likely (Caprio and Summers, 1996 and Hellman et al., 1994). That is, the benefits of financial liberalization is offset by increased vulnerability to banking crisis, if not sufficient attention is given to the institutional framework that will support a well functioning and open financial system. This suggests that institutional development needs to be emphasized early in the liberalization process and since this requires time (training of supervisor and bank managers, setting up institutions, etc.), a gradual path to financial liberalization is recommended. Furthermore, more thought is needed when designing appropriate prudential regulations and supervision in developing countries.

Prior to the crisis in Indonesia, the argument regarding the optimal order of liberalization (McKinnon, 1982 and Edwards, 1984) was that, whilst conventional wisdom could dictate a certain sequence of liberalization, reality was that reforms were based on more pragmatic considerations of "doability". Financial sector liberalization in Indonesia faced less resistance because more than half of the sector was state owned. In comparison, there was more resistance to real sector liberalization initially as the vested interests were far greater. In the early 1990s, various analyses of Indonesian reform noted the vulnerabilities of reverse sequencing of Indonesian reforms with respect to financial sector liberalization prior to real sector liberalization, and with an open capital account as an initial starting point.[4] Concerns were raised with regard to institutional weaknesses and the vulnerabilities from weak governance and lack of transparency in the financial and corporate sector. However, high growth meant that these vulnerabilities, whilst recognized, were not adequately addressed.

The first lesson that emerged early on in the crisis was that structural weaknesses precipitated the crisis or at least made the crisis worse (i.e. lasting longer and with deeper effect). Therefore, the way to prevent future crisis was to correct the structural weaknesses amounting to financial sector (prudential) bad governance and relationship banking. As such the subsequent recommendations for reforms, especially for the countries under an IMF programme, were related to meeting the G-7 codes of conduct, with some unrealistic expectations that they would be met within a short span of time.

With hindsight, what should have Indonesia done? What could other countries learn from Indonesia? If a country already has an open capital account, then one has to be cautious about opening up and managing the foreign exchange risks. There needs to be stricter requirements on who and how foreign exchange transactions can be conducted, and certainly for an improved reporting practice. Institutions are key. If there is inability for supervision and regulatory capacity, then a stepwise liberalization needs to be considered. This could be a combination of real corporatization and eventual privatization of state banks and allowing a limited number of bona fide new entrants. Restructuring of the state banks has been an unsuccessful story on its own and this recommendation pre-dates the crisis.[5]

One old argument in Indonesia pre-crisis is that rather than allow a limited number of new entrants, whose granting of licenses will then be subjected to rent seeking and intensive lobbying, it was better to allow everyone to enter subject to certain criteria. This argument is probably a good one for countries where such selectivity would be a problem. The key is of course to set the criteria sufficiently strict and with the end goal in mind, desirability of new entrants in introducing fair competition, technology, best practices and risk appropriate behaviour. The criteria should be a combination of sufficiently high capital, proven track record of the entrant (foreign bank or fit and proper managers/directors).

Many of the recommendations for actions and conditionalities in the IMF reform programmes predicate on what was thought to be the causes of the crisis and the structural vulnerabilities which led to longer and deeper crisis. Therefore, it is important to have a synthesis of the outcome of this debate three years down the road, with more analysis and hindsight behind us.

III. Lessons learned in systemic bank crisis management and restructuring

It is by now evident that mistakes were made in the initial responses to the crisis by the Government as well as the international financial institutions, which made the systemic crisis worse and the eventual cost of managing the crisis higher than should have been the case. What is the conventional wisdom on bank restructuring? What are the main lessons that should be learned from these mistakes?

A. Conventional wisdom on bank restructuring

Based on international experience and studies, there are various options for undertaking bank restructuring. All the options entail tradeoffs between speed of restructuring, fiscal costs, incentives for bank performance and confidence in the banking system (Claessens, 1998). At one extreme, bailouts would be the fastest option, but these would entail both the highest fiscal cost and the greatest disincentive for bank performance and financial discipline, and also not increase the confidence of the banking system. In the East Asian crisis, it is not surprising that this option was not taken, and especially during the systemic banking crisis that faced Indonesia. The other extreme would be to close down unviable banks and pay off creditors and depositors. This would also be speedy, send a strong signal about financial discipline, and involve relatively low fiscal costs (depending on the extent of unviable institutions), but would have a dire effect on the confidence of the banking system. The outcome was that most East Asian governments chose the intermediate path for restructuring, of selective closures of the most unviable banks, combined with one of the other options of facilitating mergers of banks or recapitalize distressed banks with the option to sell the banks at a later date. These options were thought to involve lower fiscal costs; moderate to better incentives for better bank performance; and potential for restoring the confidence in the banking system.

The experience of other bank crises, including the lessons learned thus far in East Asian bank restructuring (Claessens et al., 1999) suggests that there are some key principles that should be adhered to correct the banking system in response to the crisis and restructuring the banking system. First, only viable institutions should remain in operation; costs of restructuring should be allocated in a transparent manner, while minimizing costs to tax payers; and restructuring should be done in a way that strengthens good financial sector governance by allocating losses to existing shareholders, creditors and perhaps large depositors. Second, the measures introduced and implementation thereof should also ensure that the incentives for new private capital are preserved and that there is discipline toward bank borrowers.

Box 2

SEQUENCING OF BANK RESTRUCTURING

1. *Responding to acute crisis: to stop panic and bank runs*
   - Crisis: over leveraging, denial of government and bank owners;
   - Bank runs intensify, confidence falters: central bank provides liquidity credit with the intention of sterilizing the liquidity support so as not to loose monetary control;
   - If liquidity credit fails to stem runs: introduce deposit or blanket guarantee scheme.

2. *Stabilizing and restructuring the banking system*
   - Consolidate, recognize losses, take over, close down, merger;
   - Recapitalize viable banks;
   - Introduce new rules and regulations.

3. *Recovery to normal banking system*
   - Nationalized banks are privatized, corporate debt restructured, bad assets sold;
   - Phase out blanket guarantee and replace with normal deposit insurance scheme.

Source: Lindgren et al., 1999.

Finally restructuring needs to occur at a sufficient pace to restore credit while maintaining confidence in the banking system.

Based on past experience there are also recommendations with regard to the sequencing of bank restructuring (box 2).

How did the responses actually undertaken compare with conventional wisdom and what can be learned from these lessons? In applying the conventional wisdom to managing the crisis in Indonesia, what were the lessons learned and could the mistakes have been avoided?

B. Initial responses to the bank crisis

Prior to the entry of the IMF, the initial responses by the Indonesian authorities were actually very similar to the conventional wisdom of IMF programmes: raise interest rates, fiscal austerity, freeing up the exchange rate and addressing the weaknesses in the banking sector. However, the lack of credibility of the programme and the inconsistent approach to interest rate increases led to loss of confidence.

The Indonesian authorities responded to the float of the Thai baht in July 1997 by initially widening the exchange rate band with the first wave of capital outflow from international mutual and hedge funds, and finally floated the rupiah in mid-August (box 3). Monetary policy was tightened considerably, with overnight call rates increasing to 81 per cent and Bank Indonesia Certificate (Sertifikat Bank Indonesia, SBI) rates doubling from 12 to 30 per cent. However, the rupiah continued to weaken and depreciated even further as corporations with large and unhedged external debt tried to cover their positions. The combination of rupiah depreciation, high interest rates and problems experienced by over-leveraged borrowers led to the first round of effects on the banking system and Bank Indonesia had already begun to provide liquidity support to some banks.

In early September 1997 the Government, to respond to the crisis announced a number of steps

Box 3

CHRONOLOGY JULY TO OCTOBER 1997

2 July:	Thai baht floated.
11 July:	Peso floated; widen band on Rupiah float.
14 August:	Rupiah floated. Finance Minister ordered Rp3.4 trillion deposits (10 per cent base money) of state enterprise deposits to be transferred to Central Bank Certificates. Short-term interest rates rose and SBI doubled; announced plans to merge state banks and reshuffled senior management of state banks.
20 August:	Banks beginning to feel stress, shortage of liquidity and high interest rates, corporations scrambled to cover foreign exchange exposures.
3 September:	Announce broad government stabilization plan: ease bank liquidity and interest rates, budget revisions (especially cancellation of mega projects) to counter decline in revenues, deregulation in real sector, closure of insolvent banks and 49 per cent limit of foreign purchases on IPO lifted. Lack of specifics, timelines or concrete follow up in the following weeks. Monetary policy eased too quickly, 20 per cent early September to 16 per cent by mid-October.
16 September:	Review and postponement of private and public mega projects, postponement, short of cancellation.
18 September:	Go-ahead for 15 well connected projects even though they figured in postponed or review list, as long as had sufficient funding. Undermine credibility and missed opportunity to send signal of commitment to macro stabilization and reforms on own initiative, instead of negotiating with IMF.
8 October:	Continued weakening of rupiah, BI had to intervene continuously, and market scepticism of seriousness of President Suharto/Government to undertake reforms. Finally Government turned to IMF assistance.
31 October:	First IMF stabilization package: strong macroeconomic programme, structural reforms especially strengthening financial sector. Amount of assistance large and various mistakes in implementation.

such as fiscal austerity, postponing private power projects related to President Suharto's children, and a plan to restructure the banking sector which would include closures of unsound banks. However, the programme was ambiguous and lacked specificity and more importantly the perception was that the programme would not be implemented seriously. The Government, under pressure from the business sector, also undertook measures to loosen monetary stance and reduce interest rates, which sent conflicting signals about monetary policy and led to further capital outflow. Finally, amidst worsening confidence and weakening rupiah, the Government announced that Indonesia would ask the IMF for assistance.

In a departure from past crises where technocratic ministers were able to convince and were supported by the leadership to undertake necessary steps and utilized crises to push needed reforms, Indonesia requested for assistance from the IMF. On 1 November 1997, the Government of Indonesia signed the first IMF letter of intent (LOI). The initial IMF package has been criticized for several reasons, some of which the IMF itself has now acknowledged. The first reason is the broadness of the package itself. The "conditionalities" included the usual IMF menu of macroeconomic stabilization measures[6] but also included issues on the environment and the inclusion of structural measures including in banking sector. Second there were also some severe deadlines imposed on meeting these conditionalities. It was unrealistic to expect that these conditionalities would be met by the Government of Indonesia within the short time given (three years), because the reforms involved major changes in the law, setting up new institutions or changing existing institutions radically, and the way policy and regulations were to be implemented. In particular the push on structural reforms that were to be taken as the "signal" of President Suharto's commitment to reforms, such as those affecting his children's businesses, represented a serious miscalculation on the part of the technocrats and the IMF. The outcome was a resistance from the President and reversals of the announced reforms that led to a worsening crisis of confidence. The technocrats and the IMF miscalculated the way the package of reforms worked on "confidence".

The IMF position was that structural reforms, especially in the financial and corporate sectors, were crucial to stabilization. It is not clear whether the technocrats were supporting this approach, or responded to IMF pressure. Based on experience, it seems probable that the technocrats were using the crisis, now with external pressure, to get President Suharto to undertake reforms in areas to which he was resistant (particularly where it concerns the economic activities of his children). In the past, the argument was also that such measures were needed to indicate the seriousness of the President's political will to undertake reforms and thus build confidence. However, this time, a serious miscalculation had been made and the push was made too far and too wide, including using external pressure that was unlike the previous occasions.

Focusing in more detail on the bank restructuring component of the reform package, the initial responses were partly in accordance with the "conventional wisdom" of what was still being perceived as a limited banking crisis, and quite comprehensive; i.e. the immediate closure of 16 small and deeply insolvent banks (market share: 2.5 per cent), and the introduction of a guarantee scheme to ensure continued confidence in the banking system. The protection scheme was limited to small depositors of up to Rp20 million (around US$ 6,000), which accounted for 90 per cent of the number of depositors in the banking system. In addition, the package included intensifying the supervision of 34 of the largest private banks; rehabilitation and surveillance plans for a number of smaller private banks; and reforms of the state banks in accordance with World Bank recommendations (i.e. rationalization, mergers, privatization and recovery of bad debts) (Kenward, 1999).

The strategy of a comprehensive package of structural reforms and a large amount of assistance amounting to $10.1 billion (4 times Indonesia's quota), shored up in the first few days with intervention to the tune of $4 billion by a concerted action of central banks to strengthen the rupiah, was intended to restore confidence. Indeed the rupiah strengthened by around 10 per cent. However, this was short-lived and after two weeks began to falter because the closures of the banks were not well planned and executed. First, despite the fact that bank closures were widely expected prior to the first IMF LOI, the fact that the banks that were closed did not include the ones already weak or inactive such as Bappindo, Bank Pacific and some others, raised the question of the arbitrariness of the criteria. The criteria and the main contents of the first IMF LOI was never made clear or publicly available (as was the case with subsequent IMF LOI). Lack of clarity with regard to the criteria led to speculation that more banks would be closed – especially since the names of the other 34 banks that were to be rehabilitated were not made known. The lack of transparency and arbitrariness was worsened when the son of the President, owner of one of the closed banks, challenged the Minister of Finance regarding the closure of his bank. The outcome was that the bank remained closed, but was resurrected by subsuming it under the license of another bank. This was the first indication that the President was not going to adhere to the IMF reforms, and this perception had a serious effect on confidence.

Second, the deposit guarantee of Rp20 million did not provide the comfort level needed and domestic investors began to withdraw their deposits from private banks and transfer them to state banks (i.e. a flight to "safety" rather than quality) or foreign banks, or repatriated the funds abroad. This marked the onset of domestic capital outflows, which worsened rapidly in December 1997 as the crisis of confidence deepened. At this time the crisis of confidence deepened due to rumours of further bank closures, about the illness of the President and the death of Sudono Salim – the captain of the largest business conglomerate and owner of the largest bank, Bank Central Asia, and the firing of the Central Bank governor. By mid-December, 154 banks (half of the total assets of the banking system) had faced a run on their deposits and throughout this month Bank Indonesia's liquidity support to banks increased from Rp13 trillion to Rp31 trillion, or 5 per cent of GDP. In effect the liquidity support was funnelled abroad (Lindgren et al., 1999). Announcements of restructuring of the state banks with the merger of four of the state banks (Bappindo, BBD, BDN and Bexim) into one, and allowing one to become the subsidiary of another (BTN and BNI 1946), did little to restore confidence.

A third shortcoming was the lack of prioritization of the corporate debt problem, mainly because initially the magnitude of private external debt was not precisely known since Indonesia had an open capital account and had never enforced or monitored reporting requirements. A special task force was set up to assist private sector debtors to negotiate with creditors, but the impact of corporate distress due to the macroeconomic shocks and subsequently the effect it had on the banking sector, was not well understood by the IMF or the government economic policy makers. The macro shocks led to corporate distress and a rise in non-performing loans, and the fact that corporates had external short-term liabilities that were much higher than envisaged, and the need to roll over these liabilities became a major issue.

C. Dynamics of crisis: second round of stabilization

The crisis of confidence worsened in January 1998. With the announcement of an unrealistic budget, it became clear that the President was not committed to reforms. Decision making was undertaken without consulting with the technocrats, and the governor and four directors of the Central Bank were dismissed. The rupiah plummeted to Rp15,000 towards the end of January as bank runs and capital outflow continued. The crisis of confidence sealed the fate of the banking sector into a full-fledged systemic crisis and liquidity support from Bank Indonesia exceeded Rp60 trillion by end of January. By end-January, a number of steps were taken to restore confidence in the banking system.

1. Initial steps to restore confidence

The first step was to establish the Indonesian Bank Restructuring Agency (IBRA). It was the created as a centralized agency to assist the Government in its banking sector restructuring and recapitalization programme and was given a finite life of five years (Indonesia, 1998). At the same time the Government announced the provision of a deposit guarantee for all deposits to prevent further bank runs. IBRA has three main activities: (1) To implement the government guarantee programme, including the registration of bank's liability, premium payments, and the administering of claim verifications. The government guarantee on all bank liabilities covered both on- and off-balance sheet obligations, with subsequent automatic extensions every six months, unless an announcement is made by IBRA.[7] (2) To restructure banks through closures, mergers, recapitalizations and eventually the sale of government ownership in these troubled banks; to recover the transferred bad loans; and to monitor and sell corporate assets pledged or transferred to IBRA from former bank owners as collateral for emergency BI liquidity credits (table 3). (3) The coordination and supervision of banks that had been frozen or closed, in order to complete the whole process of closing banks.

These activities included the execution of operational activities as well as management and administration of settlement processes. Under the law[8], IBRA has been granted extraordinary powers, including certain judicial powers to execute agreements in its name, to acquire, manage, transfer and sell banks assets, and to restructure and to rehabilitate the banks under its supervision.

The immediate impact on confidence-building was relatively positive and by early February the value of the rupiah strengthened to around Rp10,000–Rp12,000. By this time 54 banks (36.4 per cent of banking sector) that had borrowed heavily from BI (more than 200 per cent of their capital and CAR less than 5 per cent) were placed under IBRA supervision. The banks included four state-owned banks (BAPINDO, Bank Bumi Daya, BDNI and Bank Exim) which accounted for one-quarter of the liabilities of the banking sector. However, the continued uncertainties regarding the implementation of the IMF reforms, including the President's apparent insistence to introduce the currency board system during February, the replacement of the head of IBRA and the political uncertainties leading up to the Presidential selection in March of that year further undermined confidence: deposit runs persisted; credit lines to domestic banks were being withdrawn;

Table 3

CHRONOLOGY OF BANK CLOSURES

	01/11/97	14/02/98	04/04/98	29/05/98	21/08/98	30/09/98	13/05/99
Private domestic banks							
Liquidated	16(2.5)	.	.	.	.	.	.
Surveillance (IBRA)	.	50(11)	37	.	.	.	.
BTO (IBRA)	.	.	6	7	4	.	11
Frozen	.	.	7	.	10	.	.
Closed	.	.	.	.	.	.	38
Merged	.	.	4	.	.	.	.
Recapitalization	.	.	.	.	.	.	9
State banks							
Surveillance	.	4(25)	3	.	.	.	.
BTO	.	.	1	.	.	.	.
Merged	.	.	.	.	.	4	.
Regional banks	.	.	.	.	.	.	.
JV and foreign	.	.	.	.	.	.	.

Note: *04/04/98*: Six private BTO banks – BUN, BDNI, Modern, Danamon, Tiara Asia, PDFCI and one BTO state bank, EXIM.
Seven frozen – Surya, Pelita, Subentra, Hokindo, Istismarat, Deka and Centris.
29/05/98: BCA was taken over.

and, liquidity support continued to increase. The Central Bank shifted from a strategy of using high interest rates to deter irresponsible usage of liquidity support, to non-market sanctions. Banks with borrowings outstanding for more than one week would be inspected by the Central Bank, which in turn had one week to report whether the banks activities should be restricted or whether the bank should be put under IBRA.

In early April, IBRA announced its first major action whereby seven of the banks (15.6 per cent of liabilities) which has borrowed more than Rp2 trillion each and accounted for over 72 per cent of total Bank Indonesia liquidity support were taken over (banks taken over (BTO)). The owners of these banks were suspended and the management was changed. Out of the seven, one was a state bank, the Bank EXIM and the other six comprised the major private banks. Seven other smaller banks (0.4 per cent of banking system) that had borrowed more than 500 per cent of their capital were closed. Learning from the previous experience of bank closures, great effort was made to assure smooth transition by ensuring that the deposits of these closed banks were directly transferred to a designated state bank, Bank Negara Indonesia on that weekend itself, and by announcing and explaining the objective criteria for closure and BTO. As a result the actions were well received by the market and only sporadic runs occurred.

In the weeks leading up to the May 1998 riots and the resignation of President Suharto the banking system was, unfortunately, hit by another big shock. The rupiah, which had stabilized at around Rp10,000 in the February–April period, destabilized again to go above Rp10,000. There ensued serious loss of confidence by both domestic and foreign investors. After these events, there were massive deposit runs on the biggest bank, Bank Central Asia (BCA), which accounted for 12 per cent of the banking system. The majority owner of BCA is the Salim group which is known to be close to President Suharto. In fact, two children of the President hold 30 per cent of the shares of BCA. The Central Bank and two state banks injected liquidity support of Rp30 trillion to BCA over the week following 16 May. On 29 May, BCA was taken over by IBRA, the shareholder's rights were suspended and management was changed. This stemmed the runs on BCA.

After the crisis of confidence in May 1998, interest rates began to rise steeply, with SBI reaching 70 per cent per annum and in banks interest rate and deposit rates also reached a 60–70 per cent level. Inflation also rose to almost 80 per cent. The negative spread experienced by the banking sector increased substantially during this period, further affecting its capital base. In October 1998, the equity of the private national and the seven state banks dropped to the negative zone, leaving a major portion of the banking sector technically insolvent. The economy contracted at close to 14 per cent in 1998 and bank NPL reached 75 per cent of total loans.

2. *Rehabilitation and recapitalization of the banking system*

After the resignation of President Suharto in May 1998, and with the Government under the leadership of the former Vice-President Habibie, there followed a few months of uncertainty with the exchange rate remaining weak and interest rates high. Little progress was made by way of bank restructuring, although much was done in terms of auditing all the banks in the banking system. It was clear that the next step of bank restructuring would involve further closures of non-viable banks and, rehabilitation and recapitalizing the remaining viable banks. Learning from their mistakes, the audits were necessary in order to have clear criteria of viability. Rehabilitation and recapitalization also needed to be linked to operational restructuring in terms of imposing a cost to the existing owners (dilution of shareholding, forced consolidation, change in ownership/management) and ensuring subsequent prudential oversight subsequently.

In a systemic bank crisis as Indonesia faced, it was clear that private capital was unlikely to be attracted without government participation. With the blanket guarantee, the cost of recapitalization became the burden of the Government. The cost of the restructuring was in turn intricately linked to the ability to resolve value-impaired assets by restructuring non-performing loans (restructuring, rescheduling, sale and swap) and sale of assets and banks taken over. The Government of Indonesia had opted for a centralized structure to resolve the sale and restructuring of assets, and this in turn led to much political interference.

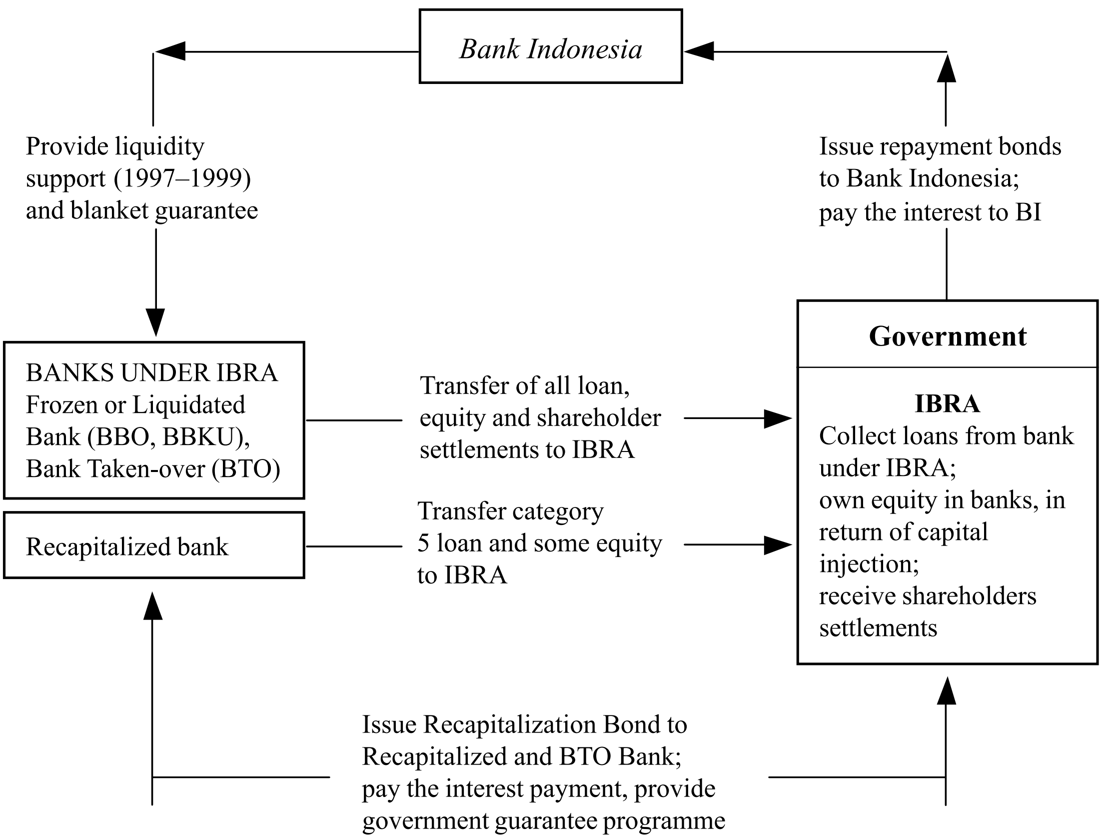
The audits revealed the complexity and magnitude of the Indonesian banking crisis. In June 1998 the result of the audits of the six private banks, which were first taken over in April 1998 revealed that (i) the average non-performing loans (NPL) reached an average of 55 per cent of loans (90 per cent in one large bank); (ii) loans were dominated by affiliated lending; and (iii) banks were deeply insolvent. On 21 August, three of these banks – Bank Umum Nasional, BDNI and Bank Modern –were declared frozen and their deposits transferred to designated state banks. The rehabilitation programme for the other three private banks were that (i) Bank Danamon was to be recapitalized by the Government and to act as a bridge bank for further mergers with other banks; and (ii) PDFCI and Bank Tiara were given a final opportunity to be recapitalized by their owners or be closed or merged with Bank Danamon. In early August the results of the other banks also revealed the weak situation of these banks and the underlying deep problems of the banking system.

The criteria for viability was based on banks' Capital Adequacy Ratio (CAR) with the following categorization: category A (CAR above 4 per cent), B (CAR between 4 per cent to negative 25 per cent) or C (CAR below negative 25 per cent). Category C Banks that failed to increase their CAR to 4 per cent within 30 days would be frozen. Category B Banks were then subjected to further classification, to the possibility of closure (BBKU, *Bank Beku Kegiatan Usaha*, or BBO, Bank Beku Operasi), recapitalization or being taken over by the Government (BTO).

IBRA moved to act against 10 of the former bank owners of the BTOs which were deemed to have violated their legal requirements. In essence they were asked to pay back the liquidity support obtained from Bank Indonesia and the amount of affiliated lending. By late September some Rp200 trillion of assets at the owners valuation had been pledged from several of these owners as well as about Rp1 trillion in cash. IBRA's advisors valued the assets at Rp92.8 trillion and tentative settlement. A protracted debate ensued as to how much cash up front owners should provide and there was political controversy as suggestions of restructuring of asset ownership emerged, including the possibility of giving some shares to cooperatives. At the end it was agreed that the obligations should be settled within

Chart 1

BANK RECAPITALIZATION SCHEME



four years and that 27 per cent be realized in the first year. This debate continues to date, as some owners have only provided very little cash and asset value is, for one reason or another, now far below than when it was first assessed (e.g. collapse in pulp prices, worsening macroeconomic conditions, etc.). Some questions are also now being raised with regard to the "fairness" of the agreements signed between the former owners and the Government.

Chart 1 shows the bank recapitalization scheme in Indonesia. It shows that the Government basically issues bonds to commercial banks as part of the recapitalization programme, and to Bank Indonesia as part of the repayment programme since Bank Indonesia has provided the liquidity support to the banking system. As already noted, the burden of recapitalization of banks was borne fully by the Government since, given the situation, one could not hope for private investors to inject capital.

(a) Private banks

IBRA moved to launch its recapitalization programme in September 1998. The objective was to recapitalize viable banks and to establish burden sharing between the Government in the form of bonds, and owners in the form of cash. The owners had the first option to reacquire their bank shares by repaying the government contribution after three years, based on an independent valuation of the bank.

To encourage owners to inject new capital, the Government allowed them to retain control over the management of the banks, although they were required to present a viable business plan. Category 5 loans, or those classified as loss were to be also transferred at zero-price to the Asset Management Unit of IBRA. Any resale of these loans would be used to buy back the government preference shares, thus giving Government the possibility to earn return on its capital injection and reduce the amount which owners need to pay to reacquire the bank.

Category A banks (i.e. CAR above 4 per cent) were deemed viable and could resume its operations. Category B banks (i.e. CAR between 4 per cent and negative 25 per cent) were declared eligible for the recapitalization programme under the condition that their respective bank owners inject 20 per cent of the total new capital required to increase CAR to 4 per cent. Bank owners of category C banks (i.e. CAR below negative 25 per cent) were given time to boost their respective bank's equity position. Those banks, whose owners failed to inject additional capital requirements, would be closed. For those in category B, but whose owners couldn't meet the additional capital requirements there was still a chance of being taken over by IBRA (BTO) provided that the bank had sufficient depositor base and branch coverage.

Despite the clear criteria, the implementation of the recapitalization programme experienced various delays due to political uncertainties and intense lobbying by owner of banks that were in danger of being closed down for not having complied with CAR. In the end, after a one-month delay and political compromises, some banks which should have been closed ended up being taken over by the Government. These glitches further affected confidence and the rupiah weakened again to Rp10,000. In mid-March 1999 the Government announced that there were 73 category "A" banks out of the 140 banks which did not need government support; nine banks making up 10 per cent of the banking system were categorized as B and eligible for the recapitalization programme; 38 banks (5 per cent banking sector) were closed; and seven banks (2 per cent of banking system) were taken over by IBRA. The owners and managers of the "A" banks also had to be reviewed by the fit and proper test, and one third did not pass the test. The managers and commissioners who did not pass the test had to be replaced, and owners who did not pass the test were given 90 days to divest their shares.

Of the nine category B banks were given five weeks to inject additional capital, seven met the 20 April deadline. Among these were the three larger banks –Bank Internasional Indonesia (Sinar Mas Group), Lippo (Lippo Group) and Universal (Astra Group), and the four smaller-sized banks – Bukopin (Cooperative Bank), Prima Ekspress, Arta Media and Patriot. Two others – Bank Bali and Bank Niaga experienced problems. Bank Bali was in the midst of negotiations with Standard Chartered to take over their shares when the corruption scandal broke. In the end IBRA, had to take over Bank Bali. In the case of Bank Niaga, the major shareholder did not come through and in the end was also taken over by IBRA. Among the 13 banks taken over by IBRA, nine were merged with Danamon, while the BCA, Bank Bali and Bank Niaga were recapitalized.

IBRA negotiated performance contracts and MOUs with the owners and management of the eight banks to be recapitalized by taking ordinary stocks and allowing management control to the owners of the banks. The estimated amount needed for recapitalization had been set in September 1998. Since then, however, the economic and political situation in fact did not much improve and by May, in the period leading up to the elections, the economy had not recovered and the rupiah remained weak. Thus, by May 1999, the updated audits indicated that the amounts needed for recapitalization would be almost double than what was originally predicted.

(b) State banks

The progress on restructuring state banks has been much slower. As already noted one bank (Bank Exim) was taken over by IBRA and another four were merged. The corporate business segment of Bank Rakyat Indonesia (BRI) was also moved into the newly merged bank, Bank Mandiri, and BRI was to concentrate on small businesses. The non-performing loans of the four merged banks were transferred to the Asset Management Unit of IBRA. Although the consolidation of the state banks has been termed as a merger, it more aptly resembles the closure of 4 banks and consolidating the remaining performing assets in one single bank (Bank Mandiri). The management of Bank Mandiri was entrusted to professionals with technical assistance from Deutsche Bank, and steps were taken to consolidate the bank and change the management style. Half of the staff has been retrenched and branches have been closed.

Box 4

SUMMARY OF BANK RESTRUCTURING AS OF 1999

	No. of banks before restructuring	*Bank category A*	*B*	*C*	*Restructuring process*	*No. of banks after restructuring*
State banks	7	-	-	7	4 merged into 1 1 new bank (export) All recapitalized	5
RDBs	27	13	10	4	12 recapilatized	27
Private national banks	142	72	40	30	48 closed 7 recapitalized 13 BTO	92

Source: Kompas (Indonesian daily newspaper), and estimates.

Table 4

SUMMARY OF BANK INDUSTRY HIGHLIGHTS, END-1999

	State bank		*Private bank*		*Regional development bank*		*Foreign/JV bank*	
31 December:	*1997*	*1999*	*1997*	*1999*	*1997*	*1999*	*1997*	*1999*
Number of banks	7	5	144	92	27	27	44	41
Branches/bk	218	316	29	39	20	20	2	2
Assets (IDR tn)	201.9	417.3	248.7	291.6	12.3	18.8	75.2	102.4
Loans (IDR tn)	153.3	112.3	168.7	56.0	7.5	6.8	48.6	50.0
Deposits (IDR tn)	133.0	312.2	177.2	252.9	8.8	14.0	38.6	72.3
Capital (IDR tn)	13.8	(17.7)	25.2	(10.2)	1.3	2.0	6.1	4.3

Source: Bank Indonesia.

Other than Bank Mandiri, there are now three remaining state banks (BNI, BTN and BRI) that have also submitted their restructuring plans.

Whereas all five of the state banks (including the newly established Bank Ekspor Indonesia), slightly less than half of the 27 Regional Development Banks (RDBs) fell under category C. However, due to the perceived importance and political sensitivity of the issue, the Government opted to maintain the state banks and RDBs. All state banks and RDBs were capitalized (box 4 and table 4).

Table 5

PUBLIC DOMESTIC DEBT

(Cumulative, in trillion rupiah)

	Recapitalization bond for recapitalized banks				Repayments bonds for Bank Indonesia				Total bonds	
Period	Variable rate bonds	Fixed rate bonds	Hedge bonds	Sub-total	BLBI[a]	Bank guarantee	KLBI[b]	Sub-total	In trillion rupiah	As per cent of GDP
December 1998	-	-	-	-	100.0	-	-	100.0	100.0	10.5
March 1999	-	-	-	-	164.5	-	-	164.5	164.5	15.0
June 1999	95.1	8.7	-	103.8	164.5	53.8	-	218.3	322.1	29.3
December 1999	203.9	51.3	26.6	281.8	164.5	53.8	9.97	228.3	510.1	46.4
December 2000	217.0	175.0	35.0	427.0	164.5	53.8	9.97	228.3	655.3	51.1
December 2001	219.5	175.5	40.4	435.3	164.5	93.8	9.97	268.3	703.6	47.2
June 2002	245.2	154.2	30.4	429.8	164.5	93.8	9.97	268.3	698.0	41.4

Source: Table 1.4 in Feridhanusetyawan and Pangestu (2002).
a Bank Indonesia Liquidity Support.
b Bank Indonesia Credit Program.

D. The cost of bank restructuring

1. The size of domestic debt

Table 5 presents the composition and size of domestic public debt, which can be classified into two categories: the recapitalization bonds for the commercial banks and the repayment bonds to Bank Indonesia. The amount of outstanding debt increased rapidly, along with the programme of bank restructuring and recapitalization from 1998 to 2000. The total government bond in December 2001 was more than Rp700 trillion, or about 50 per cent of GDP. The total amount of bond to recapitalize the banking sector was Rp435 trillion, or about 43 per cent of the total asset in all commercial banks in the country in the end of 2001. The size of government bond in the balance sheet of the banking system was certainly much larger than the total amount of outstanding credit of about Rp300 trillion. As discussed above, the increasing amount of government bonds reflects the problems of banking restructuring and the crisis of confidence which were caused by the initial closure of the 16 banks, insufficient deposit guarantee initially, delays and political interference in bank restructuring and compounded by the political crises.

There are three types of bank recapitalization bonds: (1) The variable rate bonds which are tradeable; (2) the fixed rate bonds (also tradeable); and (3) the hedge bonds which are non-tradeable and at maturity will be paid with other bonds.

The variable rate bond is based on flexible interest rates which is calculated based on the fluctuation of the three months SBI (Bank Indonesia Certificate) rates. The interest on these bonds is paid every three months, and the interest rates of these bonds are around 13 to 15 per cent at present and mature between 3 to 15 years to mature, with the first maturity already falling due in July 2002.

The fixed bonds have a fixed interest rate, varying from 12 per cent to 14 per cent per annum, and the interest is paid every six months. Due to interest rate increases experienced in 2001, the interest rate was increased to more than 17 per cent, and the Government conducted bond-exchange offers to increase the interest rate of the bond and make it more attractive, even though the weighted average of the coupon rates remains the same. These bonds now carry 10 per cent to 16.5 per cent coupon rates. These bonds have 5 to 10 years to mature, and the first maturity date would be in September 2004.

The hedge bond is hedged to an exchange rate (Rp/US$) and is used to cover the exchange rate risk by the bank due to foreign liabilities. Every three months, the interest rate is paid and the nominal value of the hedge bond is re-evaluated based on exchange rate fluctuation. If the rupiah depreciates, the nominal value of the hedge bonds will of course increase. The interest rate is SIBOR plus 3 per cent.

The total amount of repayment bonds to Bank Indonesia amounted to about Rp268 trillion in December 2001. These bonds consist mainly of the repayment bonds to cover the BLBI (Liquidity Support Bank Indonesia) channelled by Bank Indonesia from 1997–1998 (Rp164.5 trillion) and the bank guarantee provided by Bank Indonesia as part of the bank restructuring programme (Rp93.8). There are many controversies surrounding the issuance of BLBI bonds regarding the size of the liquidity support that could be much larger than the asset of the troubled bank itself; and that the assets pledged by the bank owners and shareholders in return to the support given by Bank Indonesia being significantly less than the amount of liquidity support received by these banks. In fact, the government audit agency found many irregularities in the process of channelling the liquidity by Bank Indonesia.

2. *Fiscal consequences*

Massive public debt creates serious budgetary constraints for the Government and reduces the flexibility of fiscal policies (table 6). Before the crisis, total debt service payment for the principal and interest of external debt, accounted for 26 per cent of domestic revenue. In 2002, the Government has budgeted about 45 per cent of the revenue for debt service payment, while the interest payment on the domestic bond alone accounted for more than 21 per cent of domestic revenue in 2001 and 2002. External debt service payment has been kept relatively low because of Paris Club debt rescheduling in 1998, 2000, and 2002. External debt service decreased from more than 37 per cent of domestic revenue in 1998/1999 to 13 per cent in 2000 before went up to 24 per cent in 2004.

Because of large debt obligation, the Government has been forced to reduce expenditures on development and subsidies. In 2002, about 40 per cent of total government expenditure is already committed for debt service payment and about 27 per cent will be transferred to the regional government, with the central government spending becoming residual in the budget.

3. *The real cost of banking bailout*

Government bonds were issued to banks in return for the assets that were transferred to the Government. These assets are owned by IBRA, and the net cost of bank restructuring would amount to the difference between the amounts of the bonds issued and the face value of the assets. The balance sheet of IBRA, calculated based on data in December 2001 is presented in table 7. The estimated value of total assets transferred to IBRA is Rp548 trillion, which consists of Rp275 trillion from the Asset Management Credit (AMC), Rp141 trillion from Asset Management Investment (AMI), and Rp132 trillion from the Bank Restructuring Unit (BRU).[9] The total liability, in the form of bonds issued to Bank Indonesia and to recapitalized banks, amounted to Rp703 trillion by the end of 2001. The difference between asset and liability at their book values consists of IBRA's implicit equity in state banks and the difference between the collections of shareholder settlements and the repayment bonds issued to Bank Indonesia. The revenue from asset disposal will automatically finance the cost of banking restructuring as the revenue would go to the asset side of bank's balance sheet and then reduce the amount of government recapitalization bond.

Based on the estimated market value, IBRA is expected to recover about Rp208 trillion from its total asset, or about 38 per cent recovery rate. The difference between IBRA's asset and liability at their market values represents the estimated net cost of banking restructuring in Indonesia. This out of pocket expenses that the taxpayer has to pay would be around Rp495 trillion at best, or more than 33 per cent of the GDP in 2001. But based on the actual asset recovery, the real cost is expected to be more than that. IBRA will be closed by the end of 2003,

Table 6

GOVERNMENT DEBT SERVICE PAYMENT IN GOVERNMENT BUDGET

	1996/97	*1997/98*	*1998/99*	*1999/00*	*2000*	*2001*	*2002*
In trillion rupiah							
Total: domestic + external	22.9	29.5	62.9	63.1	57.7	115.3	136.4
External	22.9	29.5	54.5	40.9	26.5	49.0	72.9
Principal	13.0	12.8	30.3	20.8	7.6	19.7	44.0
Interest	9.9	16.7	24.2	20.1	18.8	29.3	29.0
Domestic	0.0	0.0	8.4	22.2	31.2	66.3	63.4
Bond	0.0	0.0	0.0	0.0	0.0	0.0	3.9
Interest	0.0	0.0	8.4	22.2	31.2	66.3	59.5
As per cent of revenue							
Total debt service	26.1	26.3	42.8	30.9	28.1	38.4	45.2
External debt service	26.1	26.3	37.1	20.0	12.9	16.3	24.2
Domestic debt service	0.0	0.0	5.7	10.9	15.2	22.1	21.0
As per cent of expenditure							
Total debt service	29.4	26.4	37.4	27.3	26.6	32.5	39.6
External debt service	29.4	26.4	32.4	17.7	12.2	13.8	21.2
Domestic debt service	0.0	0.0	5.0	9.6	14.4	18.7	18.4
Development expenditure - central government	42.3	32.6	31.4	24.9	17.8	11.1	15.2
Balancing fund for local government	0.0	0.0	0.0	0.0	0.0	23.2	27.5
Subsidy expenditure	1.8	18.3	20.2	28.5	28.9	23.0	12.1
As per cent of GDP							
Total debt Service	4.1	4.3	6.0	5.6	5.8	7.8	8.1
External debt service	4.1	4.3	5.2	3.6	2.7	3.3	4.3
Domestic debt service	0.0	0.0	0.8	2.0	3.2	4.5	3.8
Primary fiscal balance *(per cent of GDP)*	**3.6**	**2.5**	**1.1**	**1.4**	**3.9**	**2.8**	**2.7**
Fiscal surplus/deficit *(per cent of GDP)*	**1.8**	**0.1**	**-2.0**	**-2.3**	**-1.2**	**-3.7**	**-2.5**

Source: Indonesia's State Budget and the World Bank.

and the amount of asset recovery by IBRA is estimated at about Rp111 trillion, which is about half of the targeted recovery rate. Most of the asset managed by the Asset Management Credit of Rp275 trillion has been put up for sale, and the cash proceeds reached Rp75 trillion so far, which is still lower than the targeted recovery of Rp96 trillion. In other words, it is doubtful that IBRA could meet the Rp208 trillion cumulative cash recovery target overtime, and therefore the net present value of the banking restructuring is expected to be higher. The issue is how to finance this burden overtime, so that the country could override its domestic debt without the fear of monetary or fiscal deficit explosions in the future.

The Government has not been very open about the massive loss that resulted from its bank restructuring programme. The issue is very complex, controversial, and politically sensitive. One cause for the low recovery is the delay in asset collections and disposal, due to ongoing disputes, lack of cooperation, and defaults in almost all shareholders settlements, which could not be prosecuted under weak legal system. Another is the lack of political

Table 7

THE REAL COST OF BANK RESTRUCTURING

(In trillion rupiah)

Items	*Book value*	*Expected recovery*[a]	*Actual recovery (up to August 2002)*
Total asset transferred	**548.3**	**208.354**	**111.3**
Asset Management Credit (AMC)	275.2	96.32	75.5[b]
Core/Loans asset from private and state banks	262.4		
Non-core assets	12.8		
Asset Management Investment (AMI) (Corporate equity as shareholders settlements)	141.4	76.356	17.8
Bank Restructuring Unit (BRU) (Net book-value of government investment in recapitalized and taken over banks)	131.7	39.51	18.0
Total liabilities	**703.6**	**703.6**	**703.6**
Government bond to Bank Indonesia	268.3		
Government bond to recapitalized banks	435.3		
Total assets – liabilities	**-155.3**	**-495.246**	**-587.9**

Source: IBRA and Bank Indonesia data up to December 2001.
a Calculated based on IBRA's strategic plan October 1999.
b Including the expected cash receipt from the recent asset fire-sales in June–August 2002.

support for IBRA to privatize government banks and to sell the core assets taken from these banks. There are also other problems related to governance within IBRA, as shown for example in the infamous Bank Bali case. From the liability side, the concern is that the banks might have been 'over-recapitalized' because the total bonds issued is perhaps more than what is needed. The recent asset revaluation process conducted by IBRA shows that the book value of the asset transferred to IBRA could have been overestimated.

4. Managing domestic debt

In anticipation of the difficulties of most government bonds maturing in 2004–2009, the Government has reprofiled the government bonds that are now held by various banks, i.e. by starting with the bonds matured in 2004 by replacing shorter-term recapitalization bonds with longer-term ones through exchange offer. By reprofiling the maturity of the bond, the Government could smooth-out the maturity of the bonds, extend it over longer periods of time, and avoid a massive debt burden in 2004–2009. Without reprofiling the maturity of the bond, the principal payment of the bond alone would be more Rp400 trillion during those six years.

Reprofiling only postpones the problem of managing the debt burden of the Government. For Indonesia to overcome its domestic debt burden, there has to be economic growth, and creation of deep and liquid bond market. Furthermore, the Government should avoid incurring future debt by ensuring that bank restructuring is completed and the banking system remains sound through the introduction and implementation of prudential regulations and oversight.

Unfortunately, growth has stagnated due to adverse external circumstances as well as lacklustre domestic economic management and political uncertainties. Furthermore the bond market is currently underdeveloped. Since 1 February 2000, the fixed and variable rate bonds have been traded, but the volume of transaction remains small. In June 2001, the cumulative total trading of the government bond in the market was around Rp56 trillion, which were still about one-eight of the total recapitalization bonds. The majority of investors remain the banking system itself, accounting for about 75 per cent of the total traded bonds. Bond market development has been more active since the beginning of 2002, especially when the central bank started to lower the interest rate. In mid-2002, the price of the some traded bonds, especially with 16 per cent coupon rates, hit a record level of 102. The monthly volume of transaction also increased from about Rp4 trillion in October 2001 to about Rp10 trillion in May 2002. The recent data in June 2002 show that the amount of recapitalization bonds that is no longer owned by the recapitalized bank reached Rp47 trillion or about 11 per cent of total recapitalization bonds. However, the banking system remains the major player in the bond market because non-recapitalized banks hold more than Rp24 trillion of this Rp47 trillion (Indonesia, 2002).

IV. Remaining issues and problems in bank restructuring

Despite the progress in rehabilitation and recapitalization of the banking system, there remain many challenges and problems. The banking sector remains dominated by state banks, all of which have been recapitalized, but which remain weak, or banks taken over by the state. After the restructuring the state has become dominant, either through state banks or because it has taken over or recapitalized private banks. In fact close to 85 per cent of the total banking sector third-party liabilities are owned by the Government with 13 BTOs, 80 per cent of the seven recapitalized banks under IBRA, and the remaining 4 state banks. Whilst the state banks have been recapitalized and management restructured, the problem with state banks remain numerous due to the political pressures.

The rest of the banking system is comprised mainly of the former large private banks which were taken over, merged and recapitalized and now comprising basically of four banks: BCA, the merged 10 banks under Danamon, Bank Niaga and Bank Bali. BCA has undergone divestment and Bank Niaga is also in the process of divestment. However, the market remains weak and many uncertainties surround the prospects for further divestment, especially for the state banks. The purely private banks not under IBRA are made up of 63 small-sized category A banks. There are now 26 regional development banks and 50 joint venture banks. The top four foreign banks are Citibank, Standard Chartered, ABN Amro and Hong Kong Shanghai Bank.

The problems faced by the banking sector at present are three-fold. First, even after the recapitalization, with the exception of a limited number of banks, the CAR level of most banks are still low and remain close or below the 4 per cent minimum level. Any material loan growth would easily lower a bank's CAR level as risk-weighted assets rise and capital levels stay more or less level. Moreover, recapitalization has achieved the minimum CAR by increasing the assets side of the balance sheet with government bonds, but there is no real cash to increase loans unless the bonds are sold. Should the economy recover and loan demand increase, banks would still face a problem of liquidating their government bonds in the secondary market to create funds for issuing loans. Government bonds still trade at a discount which, if too large, would in the end hurt the Bank's CAR level. The amount of recapitalization in fact was lower than what was needed then, due to the fact that although the calculations were made to cover losses up to March 1999, the actual bonds were issued 3–4 months later when the losses had gone up.

Second, earnings are also still low, reflected by very low interest margins. Banks assets still largely contain government bonds with low yields (12–13 per cent), while deposit rates are slowly rising with the weakening of the rupiah. The corresponding interest margins are often too low to cover operational costs.

Lastly, NPL levels remain high, even after the bad (category 5) loans were transferred to the AMU in IBRA. The slow economic recovery means that corporations have not yet been able to significantly improve their debt service capabilities and thus there is the likelihood of another round of losses.

A. Problems and issues

With the economic recovery projected to remain at its current "muddling" pace with a low growth of 3–4 per cent, and given the political realities, bank earnings are not expected to improve sufficiently to maintain their already low CAR levels. With NPL levels still high, even category A banks are showing earnings fatigue which, if translated into declining CAR levels, would imply a need for a second round of recapitalization. The question though is from where the source of this recapitalization forthcoming? With the government budget already spread so thin among competing and basic needs, there is limited government resource available.

This points to the market, and to the question whether private investors (both foreign and local) would be likely candidates to increase capital. There have so far been two divestments – BCA and Bank Niaga – with the former going to a financial investor and the latter to a commercial bank from Malaysia. Thus the role of foreign investors in the banking sector is likely to be limited and unlike the experience of the Latin American banking crises, foreign investors will not be the source of new capital or a source of better governance, management and know how. Further consolidation is probably in order for the Indonesian banking sector, and this process should not be delayed.

1. Completing restructuring: developing core banks?

The above discussion points to the facts that (i) the commercial banking sector remains weak and under capitalized, (ii) the number of banks still remains above 100 (low franchise value), and (iii) the state dominates 85 per cent of third party liabilities of the banking sector. The state banks are still experiencing relatively high NPLs, which could increase and remain under-capitalized. The situation is not likely to improve given the uncertainties that continue to plague economic recovery and corporate debt restructuring. Another round of cleaning out NPLs and increasing capital will therefore probably be required, along with a further consolidation of private and state banks in order to establish a number of sound core banks which would be in a position to function as financial intermediaries.

The justification for developing a smaller number of core banks is based on the following reasoning. First, given the limited number of qualified and experienced Indonesian human resources in the banking sector, fewer banks would allow surviving banks to get a larger share of this scarce resource. IBRA has resorted to using foreign bank experts to enter the management of the banks under its control, as well as using advisers and consultants. However, resorting to such means to meet the shortfall in scarce human resources is likely to be limited, given the complexities of operating in the Indonesian environment. Second, fewer banks would also ease the burden on the supervisory and monitoring tasks of the central bank (and the independent supervisory agency in the near future). Third, given the high fixed cost of developing bank technology, consolidation would allow more economies of scale. Fourth, better performance and profitability of existing banks, and the limit in the number of banks, would add to the franchise value of the bank and thereby attract private investors to inject the needed capital into the banking system.

Consolidation should not be based on deciding the number of "ideal banks", or pick winners with less-than-objective criteria. Consolidation should be based on incentive based framework and the requirements of core banks should be designed in a way to ensure risk appropriate behaviour and good governance by the owners, managers and supervisors of banks. A possible path towards further consolidation could be as follows:

With regard to state banks, it is recommended that further mergers be undertaken whereby the already merged state bank, Bank Mandiri, could be merged with Bank BNI 1946. The NPL are transferred to AMU in IBRA or a separate subsidiary for NPL of state banks. The management of the newly merged state bank should be changed and good Indonesian expertise put in place in top management. The elements of good governance over a state owned bank should also be introduced such as transparency, disclosure, ensuring independence and proper credit evaluation for providing loans (without political interference) with outside directorship or statutory body overseeing the bank, and so on. In order to raise capital, the Government could inject capital, which is linked to the change in management. Moreover, since BNI 1946 is publicly listed, capital could also be raised in the capital market. Injection of public funds, along with other steps taken to increase the franchise value of banks, will hopefully attract the interest of private investors.

With regard to private banks, another round of mergers and consolidations should be encouraged out of the remaining bulk of the private sector banking system. The corresponding few core private banks that emerge will, along with the two or three strengthened state banks, form the backbone of the banking system. The remaining 63 smaller private banks that are not under IBRA should also be encouraged to merge and consolidate to perhaps 20 or 30 and classified second-tier or community banks with a different market segment. The consolidation of the private banks should be based on the following incentive based framework that is given below.

International experience and lessons indicate that the key elements of an incentive based framework focuses on rules to ensure that core banks are financially strong and behave in a risk appropriate way. Important elements would be, first, to link determination of the minimum amount of capital and capital adequacy requirements (CAR) with increased risk. For instance it can be required that only core banks can have a foreign exchange license with high requirements on capital and CAR (e.g. 15 per cent), which will in turn encourage further consolidation. The higher level of capital requirement would imply serious initial commitment of owners and management who want to be in the banking business, and also protect the franchise value of banks from unfair and imprudent competitors (Bossone and Promisel, 1998). Additional incentives such as tax relief for bank mergers can also be provided. The experience of build up of vulnerabilities pre-crisis, given the open capital account and rapid pace of financial integration, implies that any bank providing foreign currency services and transactions should be well equipped to face volatile exchange rate movements.

Second, to ensure there is pressure for bank management to be subject to good governance, foreign exchange banks should be publicly listed. Their soundness and health ratings by the Central Bank should be published and made accessible to the public. Further, to ensure the appropriate behaviour of supervisors, the banks should also be rated by both international and local rating agencies. A similar approach was adopted in Chile where, other than government or central bank supervision of internal risks ratings and valuations of a bank, two independent private accountancy firms must audit the bank every year and their findings published. The central bank is to publish ratings based on capital requirements and the quality of the assets of the bank

Third, given the governance problems of asymmetrical information due to the concentration of ownership in the banking sector, and the problems of excessive affiliate or group lending and having banks act as the owners' business group's treasury function, it would be important to have more diversified ownership. As already mentioned, diversification of ownership through increased foreign bank ownership is likely to be limited. Widely dispersed ownership of banks may also not provide the effective oversight to banks until enforcement of prudential regulations are adequate (World Bank, 2001). Another avenue for diversification of ownership is through divestment of government shares in banks through the capital markets or through seeking financial investors. The funds raised can then be used for recapitalization. Given the past problems of excessive violation of the legal lending limit by business groups, a recommendation would be to limit the share of financial institutions that can be owned by business groups, as well as the percentage of single ownership to less than majority (e.g. 49 per cent or 25 per cent).

Fourth, banks with foreign exchange licenses need to have the capacity to manage risk. This implies very strong and proper criteria for evaluating whether bank owners and managers are "fit and proper". Bank Indonesia is at present implementing such a process.

Fifth, whilst it is not expected that foreign banks will play a role in recapitalization of the banks, foreign banks can bring in the capacity, know-how and human resources. There is also an expectation that foreign banks can introduce better governance and corporate culture.

2. *Political economy: state divestiture of assets and banks*

The most difficult problems facing a country like Indonesia are the political and social constraints to be able to institute rapid restructuring and reforms that will strengthen the financial sector. As indicated above, the ownership of banks and major corporations rests in state hands. Restructuring has already involved large losses, and how these losses should be distributed between the state, taxpayers, creditors, bank owners, borrowers and depositors is not yet completely resolved. More importantly, restructuring involves the redistribution of wealth and control, directly through restructuring of assets and liabilities, and indirectly through taxation and wage and employment adjustments (Claessens, 1998: 2). A clear consensus has not emerged in Indonesia with regard to the role of ownership and control in the banking sector or banking market between the state and the private sector, between domestic and foreign companies, and between large and small medium sized corporations. This process is likely to be politicised still, given also the ethnic dimension of predominant Chinese ownership of banks and businesses. Until these issues are resolved, progress is likely to be slow and will continue to be plagued by problems and interventions.

V. The way forward: what next?

A. *On the IMF rescue package and conditionalities*

1. *Bad handling and onerous demands*

The intention of the first IMF package was to demonstrate decisive government action in dealing with the banking system, which in turn would improve confidence in the remaining banking system. The experience in providing blanket guarantee in Thailand, with the closures of the non-bank financial institutions, led to the limited guarantee scheme, which in the end caused confidence problems. The main justification for the IMF assistance programme was to shore up confidence and to mitigate the deterioration in foreign exchange reserves due to the massive capital outflows in 1997/1978. The IMF rescue loan package is linked to an IMF Letter of Intent (LOI) and the IMF team comes at regular intervals to assess performance and to sign new LOIs. The IMF LOI that Indonesia has agreed to is very comprehensive, covering macroeconomic measures such as base money and fiscal deficit targets, structural reforms in the real sector related to trade and investment barriers being removed and financial sector restructuring. There are also a host of laws, regulations and institutional changes mandated including the independence of the central bank, competition law, bankruptcy law, a bank-restructuring agency, and a debt facilitation agency.

Indonesia has signed numerous IMF LOIs since 1 November 1997, with each LOI becoming increasingly detailed in terms of targets, timetables, and guidelines of implementation. This has been due to the deterioration of relations between IMF and the Government of Indonesia and the resulting decline in trust that occurred, especially during the second half of 2000, up to until recently. Many deadlines were missed, and the seriousness of implementation questioned, especially with regard to the transparency of the debt restructuring of major private sector obligors and asset sales under the Indonesian Bank Restructuring Agency. There have been cases where former Presidents Habibie and Wahid intervened to provide for differential treatment for certain debtors and obligors. The legal and court system have also been found lacking in their ability to enforce decisions on corruption and bankruptcy, that even when decisions were made, there have been few actual sanctions and bankruptcies. The lack of transparency and discretion has led the IMF to increasingly micromanage the LOI by creating oversight committees, independent committees and so on in an attempt to overcome the lack of authority and independence of the IBRA and of ineffective court systems. In one of the last LOI, corporate governance guiding principles were introduced and all past agreements are to be reviewed against these guidelines.

Other than lack of transparency and discretion, there were also proposals by the Government of Indonesia that the IMF could not accept, such as asset securitization of loans, and amendments to the central bank law that would allow the removal of the current board of governors.

2. *Changing thinking on IMF conditionalities*

The above description shows there were initial mistakes and unrealistic demands made under the IMF LOI. Given that Indonesia's bank restructuring remains an ongoing and problematic area of reforms, there has been much analysis, debate and change in thinking regarding what should have been done and what should be done to move forward. The IMF itself has undergone introspection that had brought about an evolution in the types of conditionalities it imposes. As is clear from the Indonesian experience, the reforms and required actions has changed from general macro and financial targets, to micro-management. Furthermore, the required actions were increasingly not just about what policies to undertake, and institutions to be set up, but also how these should be implemented with regard to the nature and terms of contracts that the government has to negotiate with banks and debtors. The shift to micro-management and implementation issues, especially with regard to transparency and governance, had a lot to do with the growing distrust between the IMF and the Government of Indonesia. However, the approach was becoming increasingly ineffective, and deadlines and targets were being continuously missed.

From the above analysis of what was done, and the results, as well as some alternatives of what could have been done, it is clear, as has been pointed out by some, that one ought to be more humble when providing detailed policy prescriptions to developing countries where there is no sure theoretical basis or conclusive empirical evidence to support the optimal policy prescriptions (Rodrik, 1999).

The second justification for the types of conditionalities being introduced, including those that have to do with transparency and governance was, according to the IMF and the negotiating team of technocrats of the Government of Indonesia, the need to instill confidence and thus encourage private capital inflows. The perception was that the signing on with the IMF was not just about assistance received, because much more funds are needed to rescue the economy. It was to instill confidence so that private capital (domestic and foreign) flows back in, interest rates come down and the currency strengthens and stabilizes. Given the confidence issue with regard to the political commitment of President Suharto, the reasoning was that transparency, strengthening financial systems, open markets, and structural reforms were necessary to restore market confidence.

However, as has been pointed out, the question whether the policy prescriptions are the best for the good of the country, or are those that the IMF believes will restore market confidence, are two different considerations. Investors for their part are heavily influenced by what the IMF, the Treasury and academic economists say (Rodrik, 1999). In the case of Indonesia, in the absence of transparency and information about companies and banks, foreign investors and creditors relied on the World Bank country reports. Was sending a signal, that President Suharto was willing to consider reforms that will affect his children, was what was needed to restore confidence? The result was in fact disastrous and a defiant President increasingly challenged the IMF and the technocrats who were initially in the negotiating team.

The IMF is now reviewing its conditionality programme and moving away from micro-management towards broader macro and financial targets.

B. Revisiting financial restructuring

The essence of the bank restructuring programme pursued by Indonesia under the IMF programme is to retain and rebuild a viable banking sector by introducing a combination of measures, tools, institutions, and incentives so as not to repeat the same vulnerabilities in the banking sector which emerged pre-crisis. Thus, the analysis of what should have been done should be undertaken at two levels. The first is with regard to reviewing whether there were alternative solutions that could have brought about better outcomes in terms of dealing with the crisis and restructuring. The second is with regard to the comprehensive programme that is now in place with the intention of addressing the vulnerabilities which were evident pre-crisis (as discussed in the next section).

1. The end game: appropriateness of second generation Washington consensus reforms. Does one size fit all?

More than half of the required actions which Indonesia has to undertake comprise of compliance to the new rules of the game, or to what has often been called the second generation Washington consensus reforms. These reforms focus on what has been perceived as the weaknesses which led to the vulnerabilities of the banking sector pre-crisis, and these weaknesses were found in the areas of corporate governance, bankruptcy procedures, business and government relations and the need for stricter prudential regulations and implementation.

The reforms are in turn often linked to international best practices and codes as are found in Basle, the Code on Good Corporate Governance, International Accounting Standards and other such institutions. Whilst Indonesia by and large and on paper has complied with many of these requirements, implementation and enforcement are far from being realized and because of institutional, legal and political constraints, may not be satisfactorily implemented satisfactorily in the near future. Furthermore, the banking sector is still weak and there remains huge confidence problem which makes it extremely difficult to phase out the blanket guarantee scheme currently in place.

In sum the problems amount to distorted incentives, inadequate information (asymmetry of information), inappropriate allocation of responsibilities and poor market infrastructure. The recommendations to respond to date in the post-crisis set of reforms include complying with international arrangements and standards in order to minimize moral hazard, to sequence liberalization consistently with the overall pace of market development and by supporting liberalization with the appropriate incentives and market discipline.

The risks associated with introducing these second generation reforms by developing countries under the IMF programmes should also be clearly understood (Rodrik, 2001). First, it reduces autonomy in the formulation of a national development policy, and asks a country to embark on an untested model of development, while precluding national experimentation with other development models. The interpretation of this risk is not because the benefits of an open capital account, good corporate governance and strengthened prudential regulations are not realized; rather, a concerted focus on developed country norms might be ignoring development goals which may conflict with those norms.

Second, too much focus on internal reforms may still not address the issues of systemic risks within which banks have to operate due to the specific circumstances and particular fragilities of the financial sector of developing countries, such as presently in Indonesia (Goodhart and Delargy, 1998). The economic environment in which the banks operate may still be one dependent on a limited set of primary products, less liquidity in the financial markets, and subject to more volatile real economic growth, inflation, nominal and real exchange rate prices, equity prices and for those with an open capital account, capital flows and the issue of confidence. As the crisis has shown, any shock to these variables will affect the balance sheet of even the sound banks, as well as corporates, which in turn affect banks. The effect is even worse for banks with undiversified portfolios (exposure to sector, particular business group or region). For instance the banks that did have an over exposure to real estate developers and were the worst hit during the crisis. Yet pre-crisis real estate developers were receiving rents in dollars and thus seemed perfectly hedged for dollar loans. However, during the crisis distressed corporations simply did not pay their rent, or could only do so with the pre-crisis exchange rates.

Developing countries are also smaller and the concentration and exposure of the economy to certain sectors or business groups are such that these countries are less able to absorb the impact from exchange rate, interest rate or aggregate demand shocks. Banks also dominate the financial sector in developing countries leading to high debt equity ratios, and greater fragility of its corporate sector to interest rate shocks as is clearly perceived from the Asian crisis.

Third, the World Bank (World Bank, 2001) points out that the banking sector is in general fragile because of the intertemporal problem of intermediation – accepting money today for some return in future. There is again all the asymmetry of information problems that lead to adverse selection and moral hazard behaviour. The banking sector is also open to the possibility of contagious deposit runs which may have begun from insolvent banks, but could spread quickly to otherwise sound banks. The financial sector is more fragile in developing countries because the problem of unavailability and inaccuracy of information is greater, leading to the inappropriate risky behaviour and related lending. A final and very important aspect of the fragility of a developing country financial sector is that the financial liberalization programme, advocated as part of the Washington consensus, a "regulatory and incentive environment ill-prepared for a market-based financial system, and in particular one that encouraged or condoned excessive risk taking" (World Bank, 2001: 89).

Fourth, the practicality of being able to undertake such extensive and comprehensive reforms, involving setting up regulatory and legal institutions and independent institutions, which took developed countries decades to do. The World Bank further points out that "Moreover, differences in institutional development and economic volatility, combined with the ability of financial market participants to adjust to regulation, mean that rather than precise forms or rules, authorities need a strategy for approaching financial sector regulation, and the strategy has to go considerably beyond convergence to industrial country norms." (World Bank, 2001: 98)

For the banking system, the most important problems are the lack of a strong and transparent accounting system which makes it difficult for bank supervisors to evaluate banks and for banks to evaluate borrowers, often leading to collateral rather than cash flow based lending. At the same time, the lack of legal protection for creditors makes it difficult to collect collateral from borrowers who default (Goodhart and Delargy, 1999: 103).

Fifth is the prevailing issue of concentration of ownership in state or private hands. In most developing countries, banks still dominate the financial system and the problem of concentration of ownership, whether in state hands or business groups prevail. Even after liberalization and deregulation, it is difficult to close down or manage state-owned banks which are often overexposed to the non-performing loans of state-owned enterprises or private companies related to the centre of power. In the case of Indonesia, due to the banking crisis it is estimated that 85 per cent of ownership is now in government hands and privatization of government ownership to date has occurred at a very slow pace. It is expected that dominant ownership, whether in state hands or with business groups, is likely to continue during and after restructuring.

Given these differences between developed and developing countries, and the wide range of differences in institutional, economic structure and political economy features, when assessing what is best for a country, one must go beyond the ideal prescriptions based on the second generation Washington consensus. One size does not fit all. What is then the ideal set of regulations and rules? Even if one knows what should be done, knowing how to get there is altogether another set of issues. Given the analysis in the above sections, it is clear that what will be crucial is the synergy between the shorter-term and longer-term goals of bank restructuring, and how one should best sequence it. How to ensure that the long-term goal is the national consensus so that it will stick? How to design the interim steps so that all move towards the end goal and not away from it? Can this be designed? Or is it impossible?

C. *Possible approaches for developing countries*

The above analysis on higher risks faced by the developing countries, due to the dominance of the banking system, the vulnerabilities to shocks and concentration of ownership of banks, often leads to the conclusions that for developing countries, the need for regulation (and with higher standards) is even greater, and that externally imposed rules and ratios to correct moral hazard and lack of incentives are more important since internal mechanisms are weak (Goodhart and Delargy, 1998).

However Barth et al. (1999) point out that while moral hazard problems and lack of incentives for risk appropriate behaviour have been found to lead to banking crises, there is no consensus on how to correct the incentive and moral hazard problems for banks so as to prevent future crises. For instance it is far from sure that requiring higher capital adequacy ratios, stricter definition and provisioning of non-performing loans, and strengthening and improving central bank supervision of banks are the most appropriate steps to be taken. This is because of differences in institutional and legal infrastructure and capacities, weak bureaucratic and judicial systems, deficiencies of data making it difficult to make accurate assessment of financial conditions of banks or their borrowers, and weak human capacity which make these reforms not easily or not at all implementable. Structural differences may also not make reform frameworks work. For instance, in Latin America there is evidence that requiring high capital standards will not necessarily work because of high levels of concentration of wealth and thin equity markets to make standards work or effectively controlled.

Therefore, much more needs to be put into thinking through an appropriate system for developing countries. Distinction should be made between regulation (establishment of specific rules of behaviour), monitoring (observing whether the rules are obeyed) and supervision (the more general observation of the behaviour of financial firms). There needs to be a balance between the three for the system to be effective, and there is a recognition that it is best to keep regulations, and thus monitoring, simple and straightforward, and steer away from detailed and prescriptive regulations (Goodhart and Delargy, 1998). One must be clear on the objective of regulation and institutional structure designed to maximize meeting the objectives.

Others have recommended an incentive based system rather than tough and non-implementable prudential standards and regulations. That is, “authorities in emerging markets should focus on using incentives to harness market forces that favour effective and efficient financial markets, and employ individual standards in so far as they contribute to this purpose” (World Bank, 2001: 92). Advocates of an incentive based system point out that, to resolve the difficulties in monitoring and enforcing international best practices in prudential regulations and supervision due to weak government capacity and lack of institutional and legal support, incentive based reforms that induce good conduct and self-policing behaviour should be considered. It is easy to adopt rules and standards, and even pre-crisis, Indonesia’s prudential regulations and standards were already converging to international best practices. CAR had already been introduced, and an 8 per cent target had been set according to the 1988 Basel Accord. However, implementation and enforcement by the supervisory authorities and the risky behaviour of the regulatory authorities, bank owners and corporates continued to be prevalent.

The question now is how developing countries, especially those under an IMF programme, are complying with the established international standards of regulations, rules, and governance, the required institutions. However, convergence of developing country to developed country norms is more on paper, and implementation in reality is still far from it. On paper, Indonesia has implemented a host of reforms and institutional changes, but it is evident from the analysis above that implementation is still a serious problem and there remains a great deal of skepticism whether behaviour and norms can change in the near future. The voluminous information needed to verify compliance to standards, the lack of an incentive system and institutional and legal capacity, mean that developing country norms are still far from those of developed countries.

What is an incentive based system? An incentive based system is defined as “system of rewards and penalties such that market participants perceive (correctly) that it is in their own best interest to behave in efficient and prudent ways” (Bossone and Promisel, 1998: 15). It is argued that such an approach is more relevant for developing countries, which have limited public and private institutions, and scarcity of information. Incentives that reward market participants for prudent behaviour (efficient capital allocation and risk appropriate behaviour) will in turn promote growth and stability. In fact this system is along the same line of thought as the prudential regulations and supervision along market compatible principles, also taking into account capacity issues, that Goodhart and Delargy advocate more generally.

The recommended components of such an incentive based system, including consideration for capacity and developing countries, and drawing on examples include: First, a simple and straightforward regulation. Given the higher risk that developing countries face, they should have simple but higher standards of CAR. There is evidence that higher levels of capital are needed to compensate for volatility in emerging markets and for exposure to foreign exchange. A case can be made for higher CAR requirements to be linked to a wider and often riskier range of activities such as foreign exchange transactions and quality of internal risk management systems. Many have recommended having capital adequacy requirements related to bank credit and market risks such as concentration of bank portfolios in particular sectors and foreign exchange exposure.

Capital adequacy is only one component of the soundness of a bank, which needs to be complemented by requirements to ensure the quality of the portfolio. The important measures are capital net true provisions for loan losses whose usefulness and accuracy depends on definition used to define non-performance, accounting standards and proper information disclosure.

Second is the introduction of portfolio diversification guidelines such as restrictions on asset growth, especially with regard to limits on risky lending, like real estate. This is intended to avoid the shocks which affect asset prices leading to an impact on the balance sheet of banks.

Third, given the vulnerabilities of not having adequate supervisory capacity pre-crisis, obviously the reform of the central bank – introducing transparency requirements, making it accountable and independent, and strengthening capacity – has been prioritized. The reality is that, legislating the setting up of an independent central bank, and having transparency and accountability requirements are not enough. Improving supervision will be a difficult task and will require time. Lack of skills can be overcome with training of supervisors as well as of managers in the banks themselves, or temporarily outsourcing if need be. The incentive structure facing supervisors should also be appropriate. Thus, to attain effective supervision and enforcement by the central bank, bank supervisors must be paid well especially as future reward (i.e. generous pension as deferred bonus) since misdeeds are difficult to determine immediately.

However, there are more fundamental problems which are not so easy to resolve. Developing countries face the problem of creating a framework for a sound banking system, whilst at the same time trying to create a broader financial system. For instance, trying to introduce good corporate governance without there being depth in the capital markets. Lack of liquidity in banks shares, and not a large portion of the shares being publicly listed means that the role of the capital markets to complement the monitoring job of supervisors and regulators is missing. Lack of equity market means that bank owners can meet capital adequacy through borrowing from their own or associated banks.

In the transition, one recommendation is to use the market for short-term bank liabilities as a source of information and policing device. If the short term liability market is functioning properly, then the risk is priced appropriately based on the perception of the soundness of the bank in question, for instance through higher interbank borrowing rates. Therefore, the guarantee on banks' third party liabilities and the implicit or explicit guarantee on banks being bailed out, or too big or too important to fail, should also be reduced or removed for the market of short term liabilities to reflect the information about the risk profiles of banks. For instance some countries have also introduced issuance of uninsured and subordinated debt by banks so that investors will monitor these banks closely.

Another problem is that banks are still controlled by vested interests, including the Government itself. The direction of institutional change is towards creation of independent institutions. Given weak supporting legal and political systems, making the concept "independence" meaningful is problematic. The conventional wisdom and direction of other central banks is for an independent central bank and the separation of monetary policy and supervision. The impact of delegation depends in turn on political polarization and the structure of agenda setting. Checks and balances are very important when there is more polarization. "Policy reformers face frustration if, in the absence of appropriate political institutions, they grant policy making authority to formally independent agencies. … Political institutions are crucial to the sustainability and effectiveness of independent agencies". (Keefer and Stasavage, 2000)

Another approach, in addition to the supervisory agency, is to have external monitors of supervisory bodies as well as banks. For instance requiring external and private agencies to monitor the regulatory institutions, to ensure that potential lack of independence and weak capacity of regulatory authorities do not undermine the soundness of the banking sector. Compulsory external audit is one way such as in Chile, where it is required that two independent accountancy firms must audit each bank yearly and make its findings public. Bank supervisors should also make public thrice yearly its findings on bank compliance. In addition to central bank supervision and rating of soundness, commercial banks could also be rated by independent credit rating agencies (Chile, Argentina, New Zealand).

External monitors that directly monitor banks would also be another way to strengthen the supervisory agency's monitoring. Even the best supervisors would still find their job difficult because of information asymmetries and such information problems affect all stakeholders, creditors, shareholders, senior bank managers and regulators.

VI. Conclusions

The experience of the Indonesian banking crisis offers the following policy lessons on avoiding or minimizing the build up of vulnerabilities as countries integrate with international financial markets. Financial liberalization needs to be preceded or accompanied by strengthening of supporting institutions and prudential regulations, and this must be accompanied by enforcement and sanctions for non-compliance. Financial integration in world financial markets implies that when exchange rate regimes are not flexible, prudential supervision of foreign currency exposures and risks, or at the very minimum monitoring of the exposures so that there is awareness of vulnerabilities, become crucial. Furthermore policy makers must be aware and be able to manage financial-macro linkages which can exacerbate macroeconomic cycles. Concentration of bank ownership makes it difficult to monitor behaviour due to asymmetric information, and had led to gross violations of prudential regulations. This implies a need to reduce dominant single ownership and/or improve substantially prudential regulations, the qualifications of owners and managers, and of course corporate governance norms and regulations to strengthen information disclosure. Finally, moral hazard problems are great when there are no clear exit mechanisms, and when there are always bail outs due to "too big or too important" to fail arguments.

The responses to a financial and banking crisis, as experienced by Indonesia, need to be gauged carefully. The important lessons here are that liquidity support, and lender of last resort facilities need to be designed in a way that do not lead to misuse and are accountable. Furthermore, failure of sterilization of liquidity to absorb excess liquidity will lead to increased liquidity which fuels inflation and capital outflows, further weakening the rupiah. Of course in the case of Indonesia, political realities need to be considered. The crisis of confidence implied that the usual relationship between capital flows no longer held, and high interest could not stem capital outflow.

The issue of avoiding a crisis of confidence in managing closures of unviable institutions is a difficult one, but the Indonesian experience underlines the importance of ensuring that closures must be accompanied by a clear explanation to the public regarding the criteria for bank closures, consistency in implementation, including a well-defined deposit guarantee scheme. The deposit guarantee scheme must be prepared in advance so that it is clear to depositors that they are able to get their money back or transfer to quality banks (Lindgren et al., 1999). Moreover, once there is a massive crisis of confidence, a limited deposit guarantee is not sufficient; a comprehensive deposit guarantee is needed. However, it is debatable whether the guarantee should have been extended to all liabilities of banks.

What are the lessons in bank restructuring? Since Indonesia is still undergoing the process, the lessons that are cited herein are preliminary. First, recapitalization was necessary, but the selection of bank viability, and the lack of uniform treatment between state and private banks were questionable. Furthermore, it would seem that the recapitalization programme was not linked to a serious restructuring programme, and as such, the danger and potential of the need for a second recapitalization has emerged. Thus, recapitalization alone is not sufficient to attract private equity injection without certainty in the direction of restructuring, low franchise value, and uncertainties in implementation of a sound banking system.

Political interference in the process has been, and continues to be, a major problem leading to delays and inconsistencies in the restructuring process. It is clear that restructuring cannot proceed without the full commitment by Government to support the agencies undertaking the restructuring. The Government could, for example, allow the IBRA sufficient independence to operate, give it protection from lawsuits and the means to attract the necessary expertise.

Asset valuation of NPLs and other value impaired bank assets remain the most difficult and intractable task of bank restructuring in Indonesia due to changing economic conditions. Yet it is key to reducing the fiscal burden of the cost of bank restructuring. The key issue is now to properly value the NPL to avoid bailing out existing shareholders, undermining private sector recapitalization and proper governance of banks. Asset disposal has been centralized in IBRA, but a concensus is not apparent with regard to the strategy of asset sales, especially with regard to the speed of disposition of assets, and how to conduct the divestiture of state ownership in banks taken over or assets taken over. It is important that valuation of NPLs should be realistic to avoid bailout of existing shareholders, undermining private sector recapitalization and proper governance of banks.

With hindsight, the policy lessons of vulnerabilities pre-crisis and the management of the crisis are clear. In moving ahead, it is important to be reminded of these policy lessons, if the same mistakes are not to be repeated. It should explain how the strengthening of the financial structure could be undertaken in the immediate and longer term. Needless to say, the re-establishment of a sound banking sector, which is part of a developed financial sector is going to take time. It will also require substantial public resources and significant changes in institutions, regulations and behaviour of the key participants.

The issues involved, and the possible way forward is evident for Indonesia. However, the magnitude of its banking sector and corporate sector distress being much greater, and since its external debt also much larger imply that Indonesia already faces a serious fiscal situation. Furthermore, Indonesia has the weakest institutional framework for resolving its banking and corporate sector problems (Claessens, 1998: 4).

Banks are only as good as their customers, as the saying goes. If we follow this argument, it means that the effective restructuring of Indonesian banks can only occur if the local economy recovers. Focusing on the banks themselves is not enough. The country's economy can only recover if there are new investments (both local and foreign) coming into the country. And whenever we talk about attracting investments, the obstacle in Indonesia right now is politics, or more aptly political stability which unfortunately is in short supply at this early phase of our democracy. Political differences among the many ethnic, regional and religious groups, which have been suppressed for so long, have risen to the surface, all at the same time. Given the inadequacies of our present political, social and legal institutions that address these divisive issues, the remedies require structural changes, which are all long-term in nature. As a result, economic recovery is most likely to progress at its current slow and "muddling" pace. In this situation, the important issue is perhaps not to be preoccupied with speed, but to keep the restructuring momentum going and ensuring it moves in the right direction.

Notes

1 Including the famous Sumarlin shock whereby Rp8 trillion of State Bank Deposits were converted into Bank Indonesia certificates (SBI) and interest rates more than doubled.

2 Finance companies alone borrowed US$ 5.1 billion in 1996, slightly more than 25 per cent of total Indonesian corporations' new debts issuance in the year, jumping from only about US$ 819 million of new debts issuance in 1995.

3 Although direct evidence on the credit channel is difficult to obtain, empirical evidence for Indonesia does suggest that economic activity is found to be more sensitive to changes in domestic credit than to changes in the money supply (Ghosh and Pangestu, 1999).

4 Literature on the sequencing of liberalization recommends that the capital account is opened after real sector and financial sector opening. Indonesia has had an open capital account since 1969 as part of the rehabilitation programme of the new order government, and this policy was never changed.

5 As was experienced by the failed World Bank programme loan to recapitalize state banks.

6 The initial response of conventional macro stabilization measures of fiscal austerity and tight monetary policy leading to high interest rates in a situation of economic contraction have been criticized heavily. The IMF changed the strategy to fiscal deficit in the subsequent IMF LOI.

7 Derivative transactions (other than currency swaps), bank liabilities to affiliated parties and shareholders of 10 per cent or more shares in the bank were excluded from this guarantee.

8 Law No. 10, 10 November 1998, amending Law No. 7 of 1992 on Banking and Government Regulation No. 17, 1997.

9 AMC was set up to restructure and dispose loans and other assets transferred to IBRA from the closed and recapitalized banks. AMI is responsible mainly for managing and disposing asset transferred by bank's shareholders in settlement of outstanding liabilities. BRU is responsible for restructuring banks in general, including administering government guarantee programme, managing transaction related to bank closure, and supervising the financial status of banks under IBRA's supervision.

References

Barth JR, Caprio Jr G and Levine R (1999). Financial regulation and performance: cross-country evidence. World Bank Policy Research Working Paper, no. 2037. Washington, DC, July.

Bossone B and Promisel L (1998). Strengthening financial systems in developing countries: the case for incentive-based financial sector reforms. Background paper. Responding to the Global Financial Crisis, Annual Meetings of the International Monetary Fund and World Bank Group. Washington, DC.

Caprio G and Summers L (1996). Financial reform: beyond laissez-faire. In: Stability of the financial system, Papadimitriou D, ed. MacMillan Press.

Claessens S (1998). *Systemic Bank and Corporate Restructuring: Experiences and Lessons for East Asia.* Background paper. World Bank Annual Meetings Program of Seminars. Washington, DC.

Claessens S, Djankov S and Klingebiel D (1999). Financial restructuring in East Asia: Halfway there? Financial Sector Discussion Paper, no. 3. Washington, DC, World Bank, September.

Demirguc-Kunt A and Detragiache E (1998). Financial liberalization and financial fragility. World Bank Policy Research Working Paper, no. 1917. Washington, DC, May.

Edwards S (1984). The order of liberalization of the external sector. Essays on International Finance, no. 156. New Jersey, Princeton University.

Feridhanusetyawan T and Pangestu M (2002). Indonesia's debt problem. CEDA Working Paper.

Goodhart C and Delargy P (1998). Financial crises: plus ça change, plus c'est la même chose. *International Finance*, December: 261–287.

Ghosh S and Pangestu M (1999). Macro financial linkages and build up of vulnerabilities. A background paper prepared for the ADB-World Bank Study on Managing Global Financial Integration in Asia: Emerging Lessons and Prospective Challenges. Draft, March.

Hellmann T, Murdock K and Stiglitz J (1997). Financial restraint and the market enhancing view. In: http://faculty-gsb.standford.edu/Hellmann/pdfs/marketenhancing/pdf.

Hugh P (2001). Corporate governance and the Indonesian financial system: a comparative perspective. Paper for the CSIS-Columbia University Joint Research Program on Indonesian Economic Institution Building in a Global Economy. USAID Partnership for Growth Project, August.

Indonesia (1998). Presidential Decree No. 27.

Indonesia (2002). Domestic Debt Management: Issues and Policy Framework. Seminar Presentation. Centre for Government Bond Management, 22 July.

Kawai M (2001). Bank and corporate restructuring in crisis-affected East Asia: from systemic collapse to reconstruction. *Pacific Economic Papers*, no. 317. Australia-Japan Research Centre, July.

Keefer P and Stasavage D (2000). Bureaucratic delegation and political institutions: When are independent central banks irrelevant? Policy Research Working Paper, no. 2356. Washington, DC, World Bank, June.

Kenward L (1999). Assessing vulnerability to financial crisis: evidence from Indonesia. *Bulletin of Indonesian Economic Studies*, 35: 71–95.

Lindgren CJ, Balino T, Enoch C, Gulde AM, Quintyn M, and Teo L (1999). Financial sector crisis and restructuring: lessons from Asia. *Occasional Paper,* no. 188. Washington, DC, International Monetary Fund.

McKinnon R (1982). The order of economic liberalization: lessons from Chile and Argentina. Carnegie-Rochester Conferences Series on Public Policy, 17: 159–186.

McLeod R (1999). Crisis-driven changes to the banking laws and regulations. *Bulletin of Indonesian Economic Studies*, 35(2): 147–154.

Pangestu M and Habir M (2001). The boom, bust and restructuring of the Indonesian banking system. Working Paper No. 02/66. Washington, DC, International Monetary Fund, April.

Pangestu M and Soesastro H (1999). The role of the IMF in Indonesia: crisis and recovery. Unpublished paper, June.

Rodrik D (1999). Governing the global economy: Does one architectural style fit all? Brookings Institution Trade Policy Forum, Conference on Governing in the Global Economy. Washington, DC, 15–16 April. Paper was revised in June.

Rodrik D (2001). Institutions for high quality growth: What they are and how to acquire them? Paper prepared for an IMF conference on Second Generation Reforms. Cambridge, MA, Harvard University, October.

Simandjuntak D and Salim F (2001). Transition to good corporate governance in post-crisis Indonesia: high barriers and windows of opportunities. Paper for the CSIS-Columbia University Joint Research Program on Indonesian Economic Institution Building in a Global Economy. USAID Partnership for Growth Project, August.

Thillainathan R (2001). The Malaysian financial system: from crisis to recovery and the way forward. Paper delivered at Sixth Shizuoka Asia-Pacific Forum, Japan, December.

Vichyanond P (2001). Complicated difficulties behind financial resolution: the case of Thailand. Paper delivered at Sixth Shizuoka Asia-Pacific Forum, Japan, December.

World Bank (2001). *Finance for Growth: Policy Choices in a Volatile World*. Washington, DC, World Bank and Oxford University Press.

G-24 Discussion Paper Series*

Research papers for the Intergovernmental Group of Twenty-Four on International Monetary Affairs

No. 22	August 2003	Ariel BUIRA	An Analysis of IMF Conditionality
No. 21	April 2003	Jim LEVINSOHN	The World Bank's Poverty Reduction Strategy Paper Approach: Good Marketing or Good Policy?
No. 20	February 2003	Devesh KAPUR	Do As I Say Not As I Do: A Critique of G-7 Proposals on Reforming the Multilateral Development Banks
No. 19	December 2002	Ravi KANBUR	International Financial Institutions and International Public Goods: Operational Implications for the World Bank
No. 18	September 2002	Ajit SINGH	Competition and Competition Policy in Emerging Markets: International and Developmental Dimensions
No. 17	April 2002	F. LÓPEZ-DE-SILANES	The Politics of Legal Reform
No. 16	January 2002	Gerardo ESQUIVEL and Felipe LARRAÍN B.	The Impact of G-3 Exchange Rate Volatility on Developing Countries
No. 15	December 2001	Peter EVANS and Martha FINNEMORE	Organizational Reform and the Expansion of the South's Voice at the Fund
No. 14	September 2001	Charles WYPLOSZ	How Risky is Financial Liberalization in the Developing Countries?
No. 13	July 2001	José Antonio OCAMPO	Recasting the International Financial Agenda
No. 12	July 2001	Yung Chul PARK and Yunjong WANG	Reform of the International Financial System and Institutions in Light of the Asian Financial Crisis
No. 11	April 2001	Aziz Ali MOHAMMED	The Future Role of the International Monetary Fund
No. 10	March 2001	JOMO K.S.	Growth After the Asian Crisis: What Remains of the East Asian Model?
No. 9	February 2001	Gordon H. HANSON	Should Countries Promote Foreign Direct Investment?
No. 8	January 2001	Ilan GOLDFAJN and Gino OLIVARES	Can Flexible Exchange Rates Still "Work" in Financially Open Economies?
No. 7	December 2000	Andrew CORNFORD	Commentary on the Financial Stability Forum's Report of the Working Group on Capital Flows
No. 6	August 2000	Devesh KAPUR and Richard WEBB	Governance-related Conditionalities of the International Financial Institutions
No. 5	June 2000	Andrés VELASCO	Exchange-rate Policies for Developing Countries: What Have We Learned? What Do We Still Not Know?
No. 4	June 2000	Katharina PISTOR	The Standardization of Law and Its Effect on Developing Economies
No. 3	May 2000	Andrew CORNFORD	The Basle Committee's Proposals for Revised Capital Standards: Rationale, Design and Possible Incidence
No. 2	May 2000	T. Ademola OYEJIDE	Interests and Options of Developing and Least-developed Countries in a New Round of Multilateral Trade Negotiations
No. 1	March 2000	Arvind PANAGARIYA	The Millennium Round and Developing Countries: Negotiating Strategies and Areas of Benefits

* ***G-24 Discussion Paper Series*** are available on the website at: **www.unctad.org**. Copies of ***G-24 Discussion Paper Series*** may be obtained from the Publications Assistant, Macroeconomic and Development Policies Branch, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development (UNCTAD), Palais des Nations, CH-1211 Geneva 10, Switzerland; e-mail: **mdpb-ed.assistant@unctad.org**.