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Author(s)	Hamada, Miki
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アジア経済研究所

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Transformation of the Financial Sector in Indonesia

Miki HAMADA
Institute of Developing Economies (IDE-JETRO)

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Transformation of the Financial Sector in Indonesia[1]

Miki Hamada

Introduction

The source and deployment of finance are central issues in economic development. Since 1966, when the Soeharto Administration was inaugurated, Indonesian economic development has relied on funds in the form of aid from international organizations and foreign countries. After the 1990s, a further abundant inflow of capital sustained a rapid economic development. Foreign funding was the basis of Indonesian economic growth. This paper will describe the mechanism for allocating funds in the Indonesian economy. It will identify the problems this mechanism generated in the Indonesian experience, and it will attempt to explain why there was a collapse of the financial system in the wake of the Asian Currency Crisis of 1997.

History of the Indonesian Financial system

The year 1966 saw the emergence of commercial banks in Indonesia. It can be said that before 1966 a financial system hardly existed, a fact commonly attributed to economic disruptions like the consecutive runs of fiscal deficit and hyperinflation under the Soekarno Administration. After 1996, with the inauguration of Soeharto, a regulatory system of financial legislation, *e.g.* central banking law and banking regulation, was introduced and implemented, and the banking sector that is the basis of the current financial system in Indonesia was built up.

The Indonesian financial structure was significantly altered at the first financial reform of 1983. Between 1966 and 1982, the banking sector consisted of Bank Indonesia (the Central Bank) and the state-owned banks. There was also a system for distributing the abundant public revenue derived from the soaring oil price of the 1970s. The public-finance distribution function, incorporated in Indonesian financial system, changed after the successive financial reforms of 1983 and 1988, when there was a move away from the

[1] This Research Paper was originally published in Japanese in March 2002.

monopoly-market style dominated by state-owned banks (which was a system of public-finance distribution that operated at the discretion of the government) towards a modern market mechanism.

The five phases of development

The Indonesian financial system developed in five phases between 1966 and the present time. The first period (1966-72) was its formative period, the second (1973-82) its policy-based finance period under soaring oil prices, the third (1983-91) its financial-reform period, the fourth (1992-97) its period of expansion, and the fifth (1998-) its period of financial restructuring.

The first section of this paper summarizes the financial policies operative during each of the periods identified above. In the second section changes to the financial sector in response to policies are examined, and an analysis of these changes shows that an important development of the financial sector occurred during the financial reform period. In the third section the focus of analysis shifts from the general financial sector to particular commercial banks' performances. In the third section changes in commercial banks' lending and fund-raising behaviour after the 1990s are analysed by comparing several banking groups in terms of their ownership and foundation time. The last section summarizes the foregoing analyses and examines the problems that remain in the Indonesian financial sector, which is still undergoing restructuring.

1. Transition of Policies in the Indonesian Financial Sector

Characteristics of the Indonesian Financial Sector

Before examining its specific policies, it is appropriate to outline the characteristics of the Indonesian financial sector: The Indonesian financial sector had been a financial system dominated by banking intermediation, or indirect finance. The volume of the Indonesian capital market continues to be very small, carrying around 200 listed companies. And these companies are not necessarily parallel with Indonesian representative companies.

Until the 1980s state-owned banks dominated the banking sector. The financial system was able to utilize the abundant funds provided by foreign aid and derived from the soaring oil prices of the 1970s. In contrast, the fall in oil prices after the 1980s reduced government revenue and caused the economy to become stagnant. In an effort to correct this, the Indonesian government cut expenditure, borrowed from private banks, floated bonds on the Euro market and took loans from the World Bank and the International Monetary Fund (IMF), and implemented two sets of comprehensive and radical financial reforms as part of its structural adjustment policy.

The liberalization of the capital account in 1970, preceding the financial reforms of the 1980s, is a fact worthy of mention. Generally, liberalization of the capital account comes last in a sequence of liberalizing moves. However, Indonesia opened its capital account very early in that sequence. The Indonesian financial sector is experiencing much more serious and acute financial problems in the wake of the Asian currency crisis of 1997 than are other countries, such as Thailand and Korea that suffered from the crisis. Those problems are most evident in the deep depreciation of the home currency (the rupiah), in the huge external debts, in the huge amount of non-performing loans, and in the enormous net capital deficiency of almost all banks.

1-1. Formative period of Financial Structure, 1966-72

The Indonesian economic system was largely transformed by the administrational change from Soekarno to Soeharto. After Soeharto, the administration put an end to hyperinflation and economic disorder, and it achieved the restoration of Indonesia to the international community. This period, 1966 to 1972, during which the process of the development of the economic system and the financial framework of Indonesia became subject to systematic scrutiny, is considered to mark the emergence of a financial structure. During that time, the Indonesian government tried to slough off the directed economic system of the Soekarno era. The government reinstated itself as a member of IMF and World Bank took measures to achieve economic stabilization by resolving the balance-of-payment crisis in accordance with the IMF's and the World Bank's guidance. The specific measures were: introduction of the discipline 'balanced budget', export promotion, utilization of foreign aid for development expenditure, open-door policy to

foreign capital, adjustment of foreign exchange rate to proper rate, removal of foreign exchange controls.

The most significant policy was the introduction of the discipline of balanced budget. At the end of the Soekarno era, inflation was terribly high: 95% in 1961, 129% in 1963, and 594% in 1965. Low economic growth and continuous fiscal-deficit expansion put the government on an inflation-finance footing. This resulted in hyperinflation (Mihira, 1995:195). The Balanced Budget Policy was introduced in order to reduce the high inflation rate to normal rate and to reduce the huge fiscal deficit.

`Balanced budget', however, means only that total revenue and expenditure are balanced. Foreign aid was treated as a part of revenue, ('development revenue'). That is, all foreign aid or development revenue was allotted to government investment or development expenditure. In short, the differences between `current revenue' and `total amount expenditure' were compensated for by foreign aid. This 'balanced budget' scheme became available after Indonesia's return to IMF membership. Thanks to that return, Indonesia could use the stand-by credit of the IMF. At the same time, the government was guided to undertake to keep fiscal deficit under 10 % of revenue. Thus the government was able to achieve a balanced budget without central-bank finance and to revive its economy with foreign aid.

Structure of the financial sector

The Indonesian financial sector was composed of the commercial-bank sector, the non commercial-bank sector and the non bank sector. The commercial bank sector included the commercial banks, the development banks, and the savings banks. The non-commercial bank sector consisted of Bank Perkreditan Rakyat [BPR]. BPR included the rural bank (the `rice and paddy bank'), the rural credit bank [LDKP], the non-rural bank (market bank, employee bank, the rural production bank [BKPD]), and the new BPR. The non-bank sector consisted of pawnshops and the insurance company, Arisan (rural informal saving scheme). As of 1968, there were 160 banks in the commercial-bank sector: five state-owned banks, one state-owned development bank, one state-owned saving bank, 23 regional government-development banks, 122 private commercial banks and 8 foreign banks (Table-1).

Loans and financial scale

Bank Indonesia's credits accounted for 30% of the commercial banks' total loans, and the state-owned banks' for 60%. Private commercial banks, which number was over 120, accounted for less than 10%. While rural banks and state-owned pawnshops also supplied credit as non-commercial and non-bank institutions, the total amount of their credit was less that 2.5% of total lending. In that period state-owned banks dominated the Indonesian financial sector. However, 40% of state owned banks' lending was financed by the Central Bank. Consequently, Indonesian commercial bank lending relied heavily on Central Bank funds.

Money supply (M2) accounted for 7.1% of GDP in 1966 and increased to 12.5% in 1971. The total amount of commercial bank loans, including the Central Bank's loans to commercial banks, was 6.3 billion rupiah in 1966, which was just 2% of GDP. In 1971 it increased to 495.3 billion rupiah and 13.5% of GDP. This development was caused by government efforts to collect savings money by curbing the high inflation rate. When the government introduced saving deposit and time deposit schemes in October 1968, banks were able to utilize the funds of the new deposits as additional funds.

Savings schemes

In 1969 the government introduced new savings schemes continuously. That was a pilot project of savings certificates similar to lottery[2]. Only some limited banks were allowed to introduce this scheme, in which the depositor bought certificates for their value or paid for them in installments. The government guaranteed both. Every month there was a draw, and holders of certificates received winning ticket for the amount of their face value, while banks had to pay an amount equivalent to one percent of their turnover to the government.

[2] As of 1 March 1971, the monthly interest rate on certificates of deposit was 1.25% for 3 months, 1.75% for 6 months and 2.25% for 12 months.

Table 1 Changes of Commercial Bank's Indicators, 1965～20

	Total Asset of All Banks	Total Lending of All Banks/GDP	State Owned Bank		Private National Bank		Regional Government Bank		Foreign/Joint Bank		Number of Banks
	Bil of Rp	(%)	Lending ratio (%)*	No. of Banks **	Lending ratio (%)*	No. of Banks ***	Lending ratio (%) *	No. of Banks	Lending ratio (%)*	No. of Banks	
1965	2	4.0	64.6	n.a.	13.1	n.a.	0.0	n.a.	0.0	n.a.	n.a.
1966	15	2.0	57.5	n.a.	18.7	n.a.	0.0	n.a.	0.0	n.a.	n.a.
1967	37	3.7	45.8	7	15.4	121	0.0	23	0.0	n.a.	n.a.
1968	119	11.7	56.2	7	7.0	122	0.0	23	1.0	8	160
1969	291	9.0	56.2	7	7.0	122	0.0	23	1.0	11	163
1970	487	10.8	64.3	7	6.8	126	0.0	25	2.3	11	169
1971	659	13.5	69.3	7	6.6	129	0.0	25	3.2	11	172
1972	983	14.4	70.0	7	6.6	126	0.0	26	4.0	11	170
1973	1.533	14.9	72.8	7	6.7	114	0.0	26	5.1	11	158
1974	2.184	14.7	72.2	7	5.7	107	0.0	26	7.4	11	151
1975	2.725	21.8	58.2	7	4.8	97	0.0	26	4.4	11	141
1976	3.509	23.1	56.3	7	5.5	91	0.0	26	4.2	11	135
1977	4.030	21.0	56.8	7	6.4	85	1.3	26	4.6	11	129
1978	5.205	23.7	52.5	7	5.5	83	1.2	26	4.9	11	127
1979	6.789	19.6	52.2	7	6.5	78	1.4	26	5.5	11	122
1980	10.122	17.3	54.6	7	7.2	76	1.8	26	5.3	11	120
1981	13.153	17.5	57.9	7	8.2	75	2.4	26	5.4	11	119
1982	15.957	20.8	61.7	7	9.2	71	2.7	26	5.1	11	115
1983	20.832	19.7	64.0	7	12.3	70	2.7	27	5.6	11	115
1984	27.768	20.9	70.9	7	16.2	69	2.7	27	5.6	11	114
1985	33.658	22.5	69.4	7	18.5	69	2.9	27	4.8	11	114
1986	40.802	23.9	67.4	7	20.9	68	2.9	27	4.6	11	114
1987	48.202	25.5	66.0	7	22.7	67	2.9	27	4.3	11	112
1988	63.284	29.5	65.1	7	24.3	66	2.7	27	4.3	11	111
1989	93.024	35.4	62.2	7	29.2	91	2.6	27	4.9	23	148
1990	132.623	46.3	54.8	7	35.8	109	2.4	27	6.3	28	171
1991	153.239	45.4	52.7	7	36.8	129	2.3	27	7.5	29	192
1992	180.148	43.8	55.2	7	34.2	144	2.4	27	7.5	30	208
1993	213,959	45.6	47.6	7	40.2	161	2.4	27	9.8	39	234
1994	248,061	59.3	35.3	7	38.0	166	###	27	8.1	40	240
1995	308,618	51.6	39.8	7	47.6	165	2.2	27	10.3	41	240
1996	387,477	55.0	37.2	7	51.2	164	2.2	27	9.4	41	239
1997	528,875	60.2	40.5	7	44.6	144	2.0	27	12.9	44	222
1998	762,428	38.9	45.3	7	39.7	130	1.3	27	13.7	44	208
1999	789,356	20.3	49.9	5	24.9	92	3.0	27	22.2	49	173
2000	984,500	20.8	37.9	5	30.6	81	3.8	26	27.7	52	164

Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

Note*: Ratio of each banks' lending amount to all commercial banks' total lending. Difference between sum of percentage in the above table and 100% is equivalent to the central bank lending.

Note**: Including one private development bank and two private saving banks.

Note***: Including one state development bank and one state saving bank.

In August 1971 the saving scheme was taken over by National Development Saving, Tabungan Pembangnan Nasional [Tabanas] and Time Insurance Saving, Tabungan Asuransi Berjangka [Tsaka]. Tabanas offered an 18%[3] annual interest rate. Depositors were in line for winning the `lottery', of which the first prize was 10,000 rupiah *per* bank-balanced of 1,000 rupiah. The draw happened once every half-year.

Taska was an insurance deposit sponsored by banks and insurance companies. Members put a certain amount of money in the bank – a minimum of 100 rupiah. In case of fatal accident their beneficiaries could immediately collect on the insurance equivalent of 13 months. Or, having deposited twelve times, members could collect an equivalent in money of 13 months of insurance at 15% annual interest rate.

These, like other newly-introduced saving schemes that offered high interest rates in order to mobilize domestic funds, generated a negative spread among banks. However, the government reimbursed the negative spread with subsidies. For example, it subsidized the interest-rate costs of commercial banks until May 1969 for these saving schemes. From October 1968 the Central Bank subsidized one-third of the interest-rate costs of state owned banks for six-month and twelve-month time-deposits. In March 1969, this subsidy was changed to 1% for twelve-month time-deposits only, and it was abolished altogether in May 1969.

Analysis

It can be concluded that the financial sector during this period was not independent. Indeed, it could be called a government subsidiary, because banking capital was financed by the Central Bank and the government. But it is undeniable that in this period the Indonesian financial system was transformed, given its ability, as a result of the termination of high inflation, to implement balanced budget and savings schemes.

This period was also a time of reform in the exchange-rate system. In 1967 the government consolidated and centralized a foreign exchange market, then a rupiah-

[3] In May 1972, in accordance with the decrease in time-deposit interest rates of state banks, the following annual interest rates were adopted: 18% for less than 100 thousands rupiah outstanding, 12% for more than 100 thousands rupiah outstanding. In 1973 these interest rates decreased to 15% and 9% respectively, and interest-rate tax was abolished.

exchange market, these having previously been several separate markets. In this period, there were four kinds of foreign exchange:

(i) Export Compensation Foreign Exchange (Devisa Bonus Ekspor);
(ii) Aid Foreign Exchange (Devisa Bantuan: mainly used for commodity aid);
(iii) Compensation Foreign Exchange (Devisa Pelengkap: compensated for the difference between government standard price and exporter price);
(iv) Automatic Allocation Foreign Exchange (Alokasi Devisa Otomatis, which is foreign exchange, of which a certain proportion of export amount is allocated to regional government.).

In the beginning of 1970, Automatic Allocation Foreign Exchange was abolished, then in April 1970 Export Compensation Foreign Exchange and Compensation Foreign Exchange integrated as General Foreign Exchange. Thus foreign exchange was of two kinds: General Foreign Exchange and Aid Foreign Exchange. In this instance the government set a limit on foreign exchange transaction concerning export and import, and it abolished other restrictions concerning any other foreign exchange transaction (Government regulation No 6, 1970). The effect of this was that Indonesia abolished foreign-exchange control at a very early stage of the formation of its financial system.

1-2. Period of Policy-based Finance under Soaring Oil Prices: 1973-82

The structure of the banking sector, with the Central Bank and the state-owned banks at its core, was established during the previous period. During the period 1973-1982, policies introduced in the previous period found structural expression in the financial system: Interest rates in some priority sectors (like rice or other grain in the agricultural sector) were set at very low levels, which caused real interest rates to register in the negative. It can be said that this period typified a regime of financial repression. The government attempted to increase financial deepening. To this end, it set deposit rates at relatively high levels. The gap between the high deposit rates and the lending rate was compensated by subsidies. Abundant oil revenue made this mechanism possible. As Binhadi explained during the period 1973 to 1982, the combination of a non-self-

sustaining financial structure and abundant oil money led the financial sector into a condition of dependence on the government:

> Monetary policy before 1983 was characterized by the provision of Bank Indonesia liquidity credit which was mainly supported by the oil boom (Binhadi [1995:13]).

In April 1974 the government announced a monetary tightening, the `Package in April 1974', to cope with the rising inflation rate. In line with it, the government capped the credit available to banks and offered them all a `liquidity fund' from which they could lend at low rates of interest. In addition to and in accordance with its development policy, the Central Bank extended direct credit to important industries. That direct credit, however, was financed also by oil revenue.

Since September 1957 banks had been obliged to maintain a reserve ratio of 30% in rupiah liquidity liability. The ratio was reduced to 15% in December 1977. From April 1974 up to 10% of banks' current liability which was deposited with the Central Bank was eligible for an annual interest-rate payment of 10%. After December 1977 this `reserve ratio' eligibility for payment was increased to 15% for current liability, but the interest rate was decreased to 6% *per annum*.

Although variation of the reserve ratio is an important instrument of monetary policy, definitions of `reserve' and `current liability' were often changed, depending on each monetary policy and type of commercial bank (state owned, private, foreign). Therefore, even though the formal reserve ratio remained constant, effective reserve ratio departed from it. Thus `reserve ratio' in this context is not a suitable gauge of the effectiveness of monetary policy.

In 1976 there was a presidential decree to the effect that the capital market had to be upgraded. The design in this was to bring foreign capital into the domestic capital market. In response to the decree, the stock exchange, which had been closed since 1968, reopened in 1977. In anticipation of this, in 1976 the government had set up three institutions charged with developing the capital market: the Committee of Capital Market Policy, the Capital Market Supervision Agency [BAPEPAM], and the state-owned underwriting company, Danareksa.

1-3. Period of Financial Reform: 1983-91

A sharp decline in oil prices in 1982 affected government revenue and its balance of payments, which had relied heavily on revenue from oil export. To meet this exigency, the government tried to work out a structural adjustment policy. In order to turn the economy away from heavy reliance on oil revenue, it devalued the rupiah and implemented deregulation and liberalization policies. Financial liberalization, taken as a series of liberalization policies, aimed to move toward a predominantly market based financial system (Wardhana, 1995: 80).

The comprehensive financial reforms of 1983 radically altered the previous financial infrastructure that had been managed by the government through the Central Bank and the state owned banks. The financial reform and the second reform of 1988 transferred Indonesia's fund allocation principle, with deregulation and liberalization at the core, from the government to the market. In 1991 the government turned its attention to prudential regulation and it started to pay close attention to soundness in banking practice. A regulatory system was designed and implemented during this period.

Details of specific policies

In June 1983 a financial reform package that proposed the complete liberalization of interest rates on deposits and credit of state-owned banks (except those of Bimas[4] and small-investment finance) was endorsed by the Cabinet. The interest rates of Tabanas (savings deposit) were increased, and bank-loan ceiling was abolished. The 20% of taxation on interest earned on foreign-currency deposits on domestic market was also abolished.

In next February 1984, the Central Bank Certification [Sertifikat Bank Indonesia: SBI] and the Discount Facility [Fasilitas Diskonto] were introduced. SBI aimed to liquidate current short-term funds among commercial banks, while Fsasilitas Dikonto aimed to supply credit to private commercial banks facing tight liquidities.

[4] BIMAS had a policy to self-sufficiency in rice and a commitment to using high-yields seeds, chemical fertilizer, agrochemical, and to arranging finance for agriculture. It was called BIMAS/INMAS: Bimbingan Massal/ Intensifikasi Massal).

In April 1984, monetary policy was eased: The Central Bank decreased discount rates from 17.5% to 16.5%. Interest rates at SBI were also decreased from 15% to 14%. Furthermore, the payment period of preferential loans from the Central Bank to state-owned banks and regional development banks was extended and the interest rates were decreased by 1%. The settlement period of inter-bank interest rates was extended from seven to ninety days.

In September 1984, the Central Bank set a ceiling on inter-bank borrowing of 7.5% of total amount of rupiah deposit in order to stabilize and improve inter-bank transactions. Alternately, the Central Bank offered to advance special liquidities to banks faced with shortage of funds. The interest on that was set at 26% *per annum*. The discount rate was increased from 16.5% *per annum* to 26%. The government also changed the frequency of Central Bank Certificate issues from once-a-week to three-times-a-week, with the view of adjusting increases in money supply in a context of expanding credit.

In October 1988, the government announced a banking-sector reform policy-package, Paket 27 Oktober 1988 [Pakto], as the second financial reform. Comprehensive reforms in the financial system were decided in accordance with it. One of its important provisions was the abolishing of restriction on the establishment of new private banks. The establishing of new private banks had been prohibited in 1968, but thanks to deregulation, that was liberalized to the extent that the only precondition that newly admitted bank's paid-up capital was 10 billion rupiah. In addition to that the nationwide opening of new branches of existing banks was also liberalized. The precondition for such openings was that the previous 24 months' business performance was good, or the previous 20 months' performance was good and the remainder months' at least sound.

The terms of dealing for foreign-exchange banks was eased too, requiring only that the previous 24 months' financial condition was good and that total asset exceeded 100 billion rupiah. At the same time, foreign banks were admitted into the Indonesian banking business[5]. (That had been prohibited since 1968.) However, their admission was conditional: newly-admitted banks had to form a partnership with a domestic private

[5] Previously, only ten foreign bank branches and Bank Perdania (joint bank with Daiwa bank) were admitted.

bank, and they had to extend their credit to the export-credit equivalent of 50% of the total outstanding credit.

Private banks became available for establishing development banks, and cooperatives for establishing ordinary commercial banks and development banks. The preconditions were that private development banks' paid up capital be more than 10 billion rupiah, and in case of cooperatives, that the sum of their basic investment funds and obligate investment funds be more than 10 billion rupiah. Existing savings banks and people-credit banks also were admitted to change their status as ordinary commercial or development banks if they were able to fulfill the foregoing conditions. New-branch opening by non-bank financial institution was deregulated too. In the second financial reform, in addition to the removal of the barriers against entering the banking business, the terms for the issue of certificates of deposit were eased. Thus savings deposits, including national development savings, started to be handled by all banks.

In the wake of the second financial reform, the number of domestic private banks rose from 66 in 1988 to 166 in 1994. New joint banks with foreign banks also increased steadily after1989. Their number reached 40, which was 3.6 times the number of those in existence in 1989.

In keeping with the increase in the number of banks, the total-loan amount also increased. Table-1 shows the ratio of total-loan amount to GDP. It shows also the ratio of state owned banks' and private banks' loan-amount to the total of all banks' loan amount. The table notes that banks' loan amounts, especially private banks, had increased rapidly after 1989.

Underpinning deregulation was guidance from the World Bank and IMF, which aimed to introduce competitive principles into the financial sector and to improve management effectiveness in the banking and non-banking sectors. Due to Pakto, state-owned enterprises and regional government enterprises were allowed to deposit to private banks and to non-financial institutions. However, deposit to private or non-financial institutions was limited to 50% of total deposit, and deposit *per* bank to 20% of total deposit.

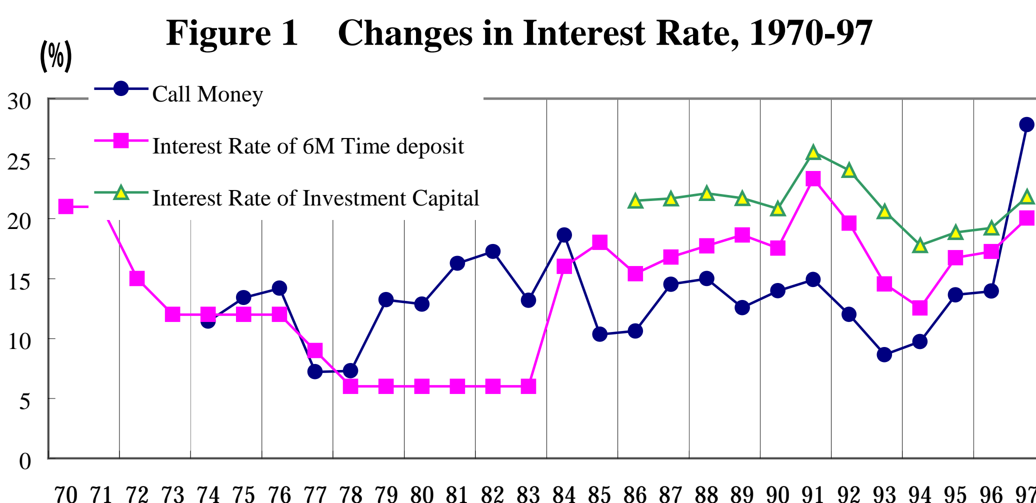
Alongside deregulation, the second financial reform provided for the prudential regulation for sound banking management. That limited the extending of credit. After the currency crisis, group lending became a serious problem and the existence of group

lending limitation was highlighted. Pakto in1988 had already stipulated that the Legal Lending Limit [LLL] to a debtor is 20% of the capital of the lending bank or financial institution, and to a debtors' group 50% of capital. Furthermore, there was a lending limit of 10% of capital to the stakeholders of a bank or non-bank institution, 25% to and stakeholder's corporate group, 5% to auditors-not-stake-holders and to corporation owned by auditors. In addition, there were limitations on lending to board members, auditors and families of stakeholders (Central Bank directors determination, No21/51, 1988).

Analysis

After the second financial reform the financial sector gained momentum for expansion. As result, money supply (M2) increased rapidly, as did the total amount of banks' lending and size of deposit. As the domestic economy also became active, domestic and foreign investment increased in line with the increase in domestic and foreign investment and investment in the real-estate sector. The expansion of investment in real estate might have been the result of abundant liquidity from the expansion of the banking sector and from the general prosperity of the domestic economy.

Figure 1 Changes in Interest Rate, 1970-97



Source: IMF, *International Financial Statistics*, various issues.

Increase in real-estate investment is prone to increase in bank's non-performing loans. Therefore the government organized a policy package for sound banking in February 1991. After 1983 the center of policies for the financial sector was 'deregulation', but in 1988 the Bank for International Settlements [BIS] set up the international standard of capital adequacy ratio [CAR] for banking soundness. This international movement encouraged Indonesian financial policy to embrace measures for the maintenance of banking soundness, like the strengthening of capital-adequacy ratio. So 1991 saw the tightening of monitory policy. As a result, deposit interest-rates for 6 months increased to 23.3% form 17.5% in previous year, and working capital interest-rates also increased 25.5% from 20.8% (Figure1).

1-4. Period of financial expansion: 1992-97

In response to the changes of circumstance in the banking sector, the governments passed Government Regulation No. 7, which required that banking management, like owners and managers, follow government guidelines. Furthermore, the government raised banks' minimum capital from 10 billions rupiah to 50 billions rupiah for commercial banks, and from 50 billion rupiah to 100 billion rupiah for foreign joint banks. Thus in contrast with the previous period, there was considerable emphasis on the supervisory function of the government and of the Central Bank with regard to commercial banks.

However, the government eventually eased some prudential regulations, like those concerning rating and the capital-adequacy ratio, because they were widely condemned as excessively burdensome for banks. On the other hand, in order to strengthen sound banking management, the government enforced observation of the Legal Lending Limit and the provision concerning non-performing loans. The banking sector saw several shifts of the policy axis during this period.

Due to tightening monetary policy in 1991, increase in non-performing loans became a problem mainly for state-owned banks, and some concrete measures for the disposal of non-performing loan were considered. The Central Bank started to emphasize the necessity of strengthening the accounting system and the legal system for achieving the settlement of non-performing loan. At the same time, the Central Bank recognized an obligation to direct 20% of the total lending fund to small and medium-size industries in

order to support the funding side of the government's development policy and poverty-reduction policy.[6]

After 1992, the effects of the second financial reform continued. The number of banks and the amount of total loans continued to increase and it was concerned that increase in these areas tended to foment speculative investment. In November 1992, Bank Summa's[7] operation was suspended because increase in non-performing loans led it into financial trouble. This context manifests the paradigm case of banking sector run into the ground by non-performing loans.

In the light of the prudential regulation included in Pakto, the government attended carefully to the capital-adequacy ratio, to group lending and to the loan-deposit ratio. Nevertheless, because of the deregulation of foreign investment in 1994, expansion of the financial sector gained momentum. The vast deregulations concerning foreign investment were the following:

(i) 100% foreign capital participation was allowed without conditions;
(ii) minimum investment limitations were abolished;
(iii) the admission-to-extension business period was set at more than thirty years;
(iv) the localization regulation, which had been required for the purpose of increasing Indonesian local capital by more than half after a certain period, was suspended.

In step with deregulation, private capital inflow increased by 2.7 times from 3.7 billion US dollar in 1994 to 10.3 billon in 1995 (Table-2). These capital inflows were mainly foreign direct investment and portfolio investment.

Total amount of loan and the ratio of total loan to GDP also had increased rapidly after 1994. The expansion was mainly absorbed by private national banks. As a

[6] For evaluating a bank's soundness, a score system of financial indicators was adopted. Since lending to small and medium enterprises (SMEs) was a bonus point, there is a possibility that banks, in quest of a high score, became prone to easy lending to SMEs. (Takeda, 1999: 196).

[7] Edward Seky Soeryadjaya, eldest son of Willian Soeryadjaya, owner of Astra Group, owned Bank Summa. His bankruptcy was brought about by a rapid increase in non-performing loans accumulated by massive group lending (IDE, eds,1992).

result, private national banks surpassed state-owned banks in total assets and total loan amounts. On the other hand, excess capital inflow shifted the primary industry for bank lending from the manufacturing sector to the service sector, which was construction and real estate. Then over-lending to specific sectors became a concern.

Table 2 Changes in Capital Account, 1960-2000 (Mil of US$)

	Capital Account	Private Capital Balance	Public Capital Balance	Errors and Omission		Capital Account	Private Capital Balance	Public Capital Balance	Errors and Omission
1960	183	20	163	-3	1981	2,111	148	1,963	-2,069
1961	354	-11	365	-1	1982	5,756	1,639	4,117	-2,229
1962	120	11	109	-40	1983	6,602	1,826	4,776	494
1963	123	10	113	-37	1984	3,622	757	2,865	-709
1964	128	25	103	14	1985	1,807	68	1,739	238
1965	271	18	253	-35	1986	4,365	1,291	3,074	-810
1966	174	50	124	-9	1987	3,652	1,548	2,104	-173
1967	341	100	241	-30	1988	2,372	407	1,965	-1,141
1968	279	45	234	-4	1989	3,090	314	2,776	-1,439
1969	346	64	282	50	1990	4,746	4,113	633	593
1970	416	103	313	-6	1991	5,829	4,410	1,419	-230
1971	473	156	317	-95	1992	6,471	5,359	1,112	-1,606
1972	805	427	378	58	1993	5,962	5,219	743	-2,923
1973	1,054	498	556	76	1994	4,008	3,701	307	-242
1974	978	382	596	-314	1995	10,589	10,253	336	-2,313
1975	285	-1,493	1,778	-104	1996	10,989	11,511	-522	1,264
1976	1,869	237	1,632	-55	1997	2,542	-338	2,880	-1,651
1977	1,325	-72	1,397	-233	1998	-3,875	-13,846	9,971	2,122
1978	1,824	333	1,491	-566	1999	-4,569	-9,922	5,353	2,079
1979	1,114	-611	1,725	-566	2000	-6,773	-9,990	3,217	3,822
1980	1,574	-630	2,204	-2,057					

Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

1-5. Period of financial restructuring: 1998 to present time

During the financial expansion period, the government recognized the increase in non-performing loan and the importance of sound banking management. Nevertheless, there was no means of improving the situation because it was happening in a time of rapid financial expansion. Then the Asian currency crisis occurred in July 1997. As a first remedy measure, the government closed sixteen private national banks in November

1997. Since those closures were executed without the provision of a safety net (like deposit insurance), the Indonesian banking sector was in complete turmoil. In addition to that, the political turbulence of 1988 led the home currency, rupiah, into deep devaluation. The devaluation hit companies' performance, many of them holding debts in US dollars, then banks' non-performing loan increased at a burst. In March 1999, the average non-performing loan ratio of all commercial banks rose to 58.7% (Table-3). In addition, expansion of liabilities in foreign currency deteriorated banks' balance sheets, with almost all banks carrying an excess of debt (Table-4).

Table 3 Changes in Non-performing Loan Ratio, 1996〜2000

（%）

	1996.3	1997.3	1998.3	1999.3	1999.1	2000.1
All Commercial Banks	10.6	9.3	19.8	58.7	32.8	18.8
State owned bank	16.6	14.2	24.2	47.5	n.a.	n.a.
Private forex bank	4.0	4.4	12.8	76.9	n.a.	n.a.
Private non-forex bank	14.7	16.5	19.9	38.9	n.a.	n.a.
Joint bank	7.4	7.7	25.3	64.6	n.a.	n.a.
Foreign bank	2.8	2.7	24.4	49.9	n.a.	n.a.
Regional development bank	18.5	13.9	15.8	17.0	n.a.	n.a.

Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.
Note: After December 1999, individual banks' figures not available due to change of publication method.

Table 4 Equity Capital / Total Assets, 1995〜2000 （%）

	1995	1996	1997	1998	1999	2000
All Commercial Banks	9.8	9.6	8.8	-12.9	-2.7	5.1
State owned bank	8.8	9.6	6.8	-8.4	-4.5	3.7
Private national bank	10.0	9.0	10.3	-13.6	-3.5	6.5
Foreign bank	8.5	8.0	4.6	3.0	1.0	0.9
Joint bank	14.7	16.1	11.6	-6.5	9.9	14.2
Regional development bank	9.5	10.3	10.6	10.4	10.8	9.3

Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

As an emergency measure, the Central Bank gave a liquidity support (Bantuan Likuiditas Bank Indonesia [BLBI]) of 164.5 trillion rupiah to fifty-six banks in order to cope with the run on banks after the closure of sixteen banks in November 1997. As a move towards comprehensive bank restructuring, the Central Bank closed several non-performing banks and selected some important banks in order to eventually set them at

the center of the Indonesian banking system. The restructuring of the banking system was implemented with a focus on these selected core banks. The selection was based on the examination by international audit firms of 166 banks in 1998.

In keeping with the result of that examination, the Central Bank divided commercial banks into three categories on the basis of their Capital Adequacy Ratio [CAR]: Category A had a CAR of more than 4%, Category B of -25% to 4%, Category C of under 25% (Takeda, 2000: 205). The government considered Category A banks sound, so they were not subjected to restructuring. Category B banks became the main subjects of restructuring. Category C banks had to increase their capital to –25% during the moratorium period of thirty days in order to become eligible for participating in the government's restructuring program. Seven state-owned banks were in Category C, but because of their size and importance, all were bailed out.

The banks subjected to restructuring were re-capitalized by government bonds to increase their CAR to 4%, and they shifted their non-collectable credits to the Asset Management Unit of Indonesian Bank Restructuring Agency [IBRA]. In May 1988 the first re-capitalization was implemented in twenty-three banks[8]. As a condition of re-capitalization, a bank or the bank's owners had to pay 20% of capital to fulfill the 4% of CAR. Where a bank was unable to fulfill that condition, it was nationalized.

By December 2000, a total of 430.4 trillion rupiah was injected into the banking sector. As a result of restructuring, sixty-eight banks were closed (including one in 2001), thirteen were nationalized, twenty-seven were re-capitalized, four state-owned banks were merged into one new state-owned bank (Bank Mandiri), one nationalized bank was merged with Bank Central Asia [BCA], and eight nationalized banks were merged to become Bank Danamon. Thus Indonesian banks were drastically reshuffled. Furthermore, the IMF imposed the condition that all commercial banks reach 8% of CAR by the end of 2001. Because it was unable to meet this regulation, Uni Bank was closed in November 2001 and a further five banks' merger was decided upon[9].

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[8] Breakdown: 7 private banks (Bank International Indonesia [BII], Lippo, Universal, Bukopin, Prima Express, Arta Media, Patriot); 4 nationalized banks (Danamon, Tiara Asia, PDFCI, Bank Central Asia) and 12 regional government banks.

[9] Merger of Five Banks: Bali, Bank Universal, Bank Prima Express, Bank Arta Media and Bank Patriot, was fixed. Bank Bali is a recapitalized and nationalized bank. The other four banks are recapitalized banks. The CAR of all of them except Bank Bali's was lower than 8%. Bank Bali was at 11.9% as of June 2001, Bank Universal at 4.1%, Bank Prima Express at 6.5%, Bank Patriot's and

At the same time bankruptcy law was enacted in order to encourage the disposal of non-performing loan and liquidation[10]. In May 1999 the central banking law was also amended.[11] This secured the independence of the Central Bank. Pursuant of that amendment, the provision of credit to agriculture, housing and small and medium enterprises, which used to be handled by Central Bank, was shifted to other institutions. The Central Bank was no longer required to supply direct credit to these sectors. The banking-supervision function of the Central Bank was also to be transferred to a new supervisory body that would be established by 2003. Thus the Central Bank's function moved from fiscal distribution to guarding the stability of exchange rates and to devising monetary policy.

2. The Financial Market's Response to Financial Policies

In the previous section, the process of transformation of the banking system was summarized as the change from a system that consisted of Central Bank and government control of credit through state-owned banks to a modern system based on market mechanism. This section will examine how the financial market responded to the financial policies introduced to bring about the transformation.

Capital inflow

Capital inflow to Indonesia consisted of public capital and private capital. Since Indonesia adopted the balanced-budget principle in 1967, a prerequisite of foreign aid, the volume of public capital inflow was decided by the Consultative Group on Indonesia [CGI].[12] Thus public capital inflow was not influenced in principle by economic policy and/or the social situation. Even so, private capital inflow fluctuated in response to changes in the political and/or economic situation (Table-2). There were five clearly-

Bank Arta Media's CAR were unknown (21 November, 2001, *Jakarta Post*).

[10] Acting Government Regulation About Amendment of Bankruptcy Law, No1, 1998, and low No. 4, 1998

[11] Act for Bank Indonesia No. 23, 1999

[12] **After the withdrawal of Holland as a chair country, IGGI changed to CGI and was chaired by the World Bank.**

discernible changes in the volume of private-capital inflow between 1966 and 2000. The first occurred at the deregulation of foreign-exchange management in 1970, the second at the liberalization of interest rates in 1983, the third at the liberalization of entry into the domestic banking business in 1988, the forth at the liberalization of foreign investment in 1994, and the fifth during the Asian currency crisis of 1977.

After the deregulation of the foreign-exchange management in 1970, private capital inflow increased in line with the rise in private foreign direct investment in 1972 and 1973. But in 1975, 1.5 billion US dollars, four times the previous year's amount, went out from Indonesia. This happened in consequence of the Pertamina Crisis. The government paid Pertamina's, a state-owned oil company, 1.5 billion US dollars in short-term debt due in 1975 out of its total debts 2.3 billion US dollars on behalf of Pertamina. In the same year the government received 1.78 billion US dollars of public capital in order to avoid an expansion of its fiscal deficit, with the result that the capital account in 1975 had a surplus of 285 million US dollars.

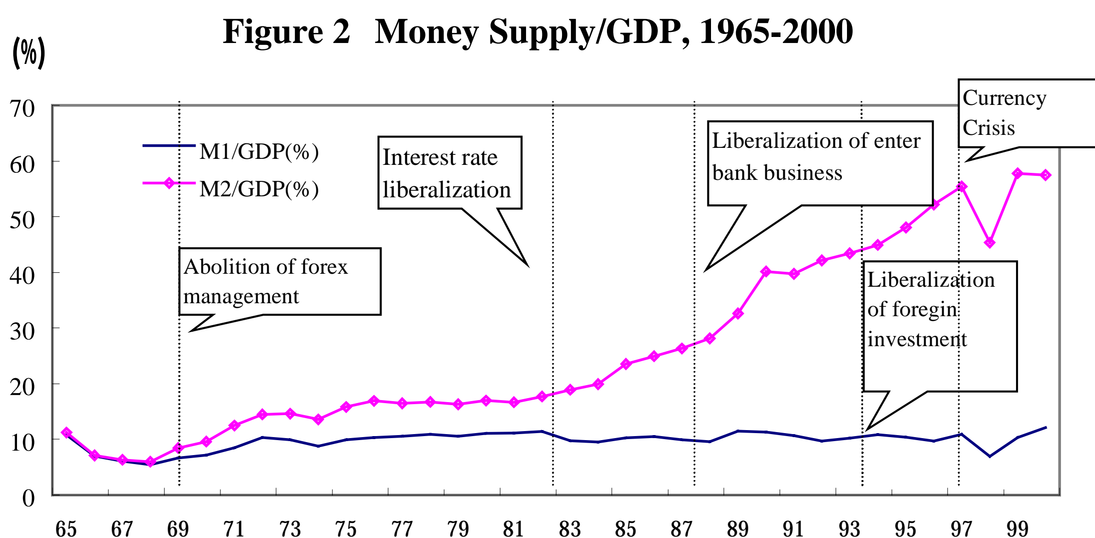
Between 1975 and 1981, private capital inflow fluctuated within a short parameter. It must be noted that there was no interruption of the volume of public capital inflow after Indonesia's receipt of 1.78 billion US dollars in 1975. While private capital inflow could not have been expected during the period when the official interest rates of state-owned banks were set by the government and real interest rates were in the negative. On the contrary, in 1982 private capital inflow increased rapidly to1.6 billion rupiah, an eleven-fold improvement upon that of the previous year.

In 1983, when the first financial reform was implemented, 1.8 billion US dollars of private capital flowed in. But in 1985 that inflow decreased to 68 million US dollars, and thereafter it became volatile. After 1990 private capital inflow developed a `continuous increase' trend. In that year the amount of inflow reached 4.1 billion US dollars; in the previous year it had been 300 million US dollars. The upward trend was maintained in subsequent years. Because of the foreign-investment liberalization in 1994 and the investment boom in East Asian countries, between 1995 and 1996 more than 10 billion US dollars came into Indonesia. A total of 25 billion US dollars flowed in during the three years until preceding 1997, when capital inflow reversed to outflow. Then, between 1997 and 1999, an almost-equivalent total, 24 billion US dollars, went out.

Capital flow and the development of the financial sector

Figure 2 shows that the ratio of money supply to GDP had increased continuously since the beginning of the 1980s, so financial deepening increased. Figure 3 shows that lending also increased proportionately with the increase in the amount of deposit. Especially after the mid-1980s, both deposit and lending rapidly expanded. We can see that after the crisis, though deposit levels were still high, lending decreased rapidly.

Figure 2 Money Supply/GDP, 1965-2000



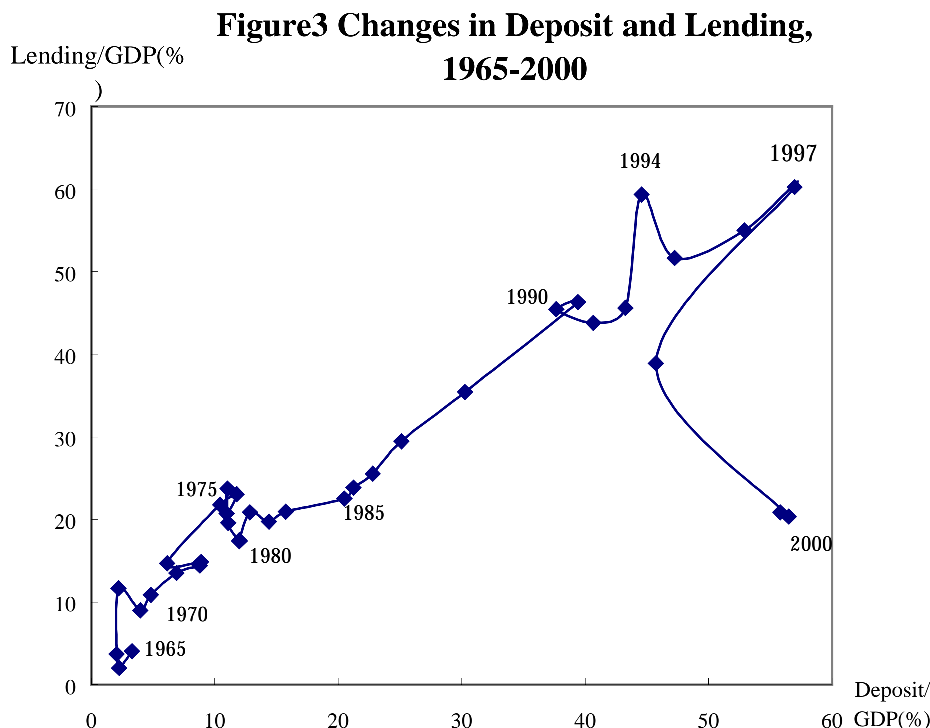
Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

Changes in the structure of assets and liabilities

After the modernization of the foreign-exchange system in 1967 and the abolition of foreign exchange controls in 1970, assets and liabilities in foreign currency increased. In 1967, assets in foreign currency accounted for 0.8% of total assets, but increased to 18.3% in 1968. Liability in foreign currency also increased from 0.7% to 18% of total assets. After the first financial reform, due to the liberalization of interest rates, the ratio of time deposit to total assets increased from 15.6% in 1982 to 22.5% in 1983. After the second reform in 1988, the liberalization of conditions for entering the domestic banking business accelerated a rise in time deposits and of lending to the private sector. Loans to the private sector accounted for 61.5% of total assets in 1988, up from 49.4% in 1983,

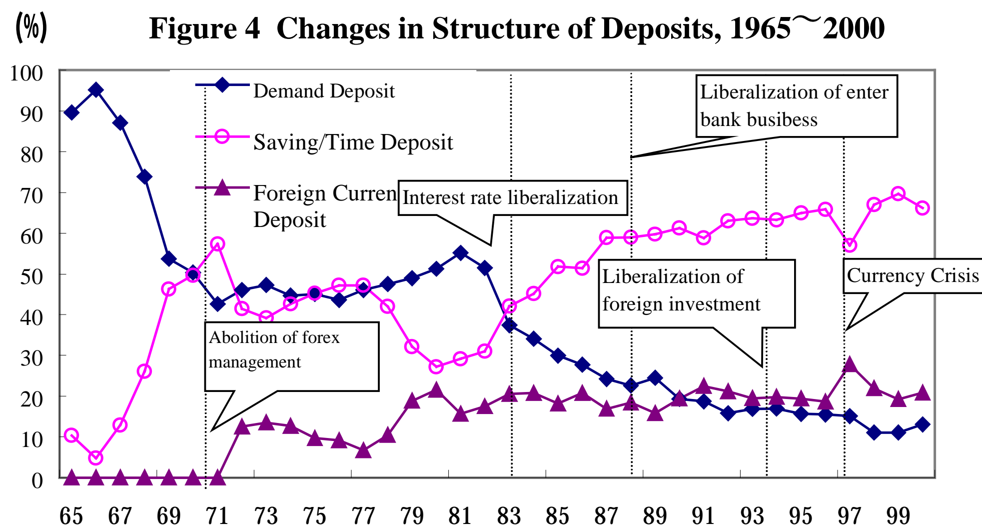
and time deposit also increased to 33.1%. Assets and liabilities in foreign currency increased after 1998 also, but that was due to the depreciation of the rupiah.

Figure3 Changes in Deposit and Lending, 1965-2000



Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

Figure 4 Changes in Structure of Deposits, 1965～2000



Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

Figure 4 shows changes in the structure of demand deposits, savings and time deposits and foreign currency deposits. Savings deposits and time deposits were formally introduced in 1968, before which demand deposits had been the dominant bank deposit. Foreign currency deposit started to increase after the abolition of foreign-exchange controls in 1970. Until the mid-1970s, demand deposits and saving/time deposits were of the same volume, but after the latter half of 1970s, the volume of saving/time deposits decreased. Although the government had set long-term interest rates at high levels in order to encourage mobilization of funds, demand deposits seem to have been preferred: people valued liquidity more than higher interest rates in a financial market that was not yet fully liberalized.

Due to the financial reforms of 1983, discretion concerning the setting of interest rates was shifted from the government to individual banks. Because of that, state-owned banks' interest rates, which dominated 80% of total deposit in banking sector, impacted on market-deposit rates, causing deposit-interest rates to rise. For example, interest rates on one-year deposits increased from 9% to19%. This increase mobilized funds to time deposit, and thus the volume of saving/time deposit became much greater than that of demand deposits. After 1988 saving/time deposit grew rapidly, and in the 1990s, foreign deposits surpassed demand deposits.

Table 5 Changes in Composition of Total Assets by Group of Ban
1987～2000

	1987	1988	1989	1990	1991	1992	1993
All commercial banks	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State owned bank*	64.7	63.0	54.8	48.7	50.9	51.8	47.0
Private national bank**	21.9	24.0	31.9	36.2	38.2	36.8	41.2
Foreign/Joint bank	5.8	5.1	5.5	7.4	8.5	8.4	9.2
Regional development bar	7.7	8.0	7.8	7.7	3.0	2.9	3.1
	1994	1995	1996	1997	1998	1999	2000
All commercial banks	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State owned bank*	42.1	39.7	36.5	38.2	40.0	49.6	51.3
Private national bank**	45.9	47.8	51.8	47.0	46.2	36.9	35.6
Foreign/Joint bank	9.5	9.8	9.2	14.2	13.0	13.0	12.5
Regional development bar	3.2	3.2	2.8	2.3	1.9	2.4	2.6

Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.
*Including one state development banks and one state saving bank.
**Including private development bank and two private saving banks.

Analysis

The two financial reforms and the massive capital inflow after the liberalization of foreign investment controls promoted the banking sector's expansion. Private national banks developed at a remarkable rate after the mid-1990s. However, after the crisis the situation relapse into its pre-liberalization state. Table 5 shows the changes in the total-assets composition of commercial banks. After 1999 state owned banks' total assets again surpassed private national banks' assets. In 2000 state-owned banks controlled more than half of all commercial banks' assets. During this harsh time, the banking sector, including almost all banks, had negative equity and many private banks were closed. All state-owned banks were bailed out in order to avoid disorder on the financial market. All state banks, including Bank Mandiri, which is the biggest bank forged from the merger of four state owned banks, were re-capitalized with 280 trillion rupiah by the government. Because uncertainty was mounting in the banking sector, many deposits were shifted for safety to state-owned banks or nationalized banks. This is the main reason why state-owned banks regained the dominant position. Foreign banks' and joint banks' volumes also increased to more than 10%. This occurred for the same reason that brought about the resurgence of state-owned banks: depositor flight to safety.

3. Analysis of Commercial Banks' Financial Indicator

It was demonstrated in the previous section that the liberalization in 1998 of conditions for entering the domestic banking business contributed to the quantitative expansion of the banking sector. Until the financial reforms, state-owned banks had dominated the Indonesian banking sector. After 1994, private national banks surpassed state-owned banks, both in total assets and total lending. Since 1994 and until the currency crisis, private national banks overtook state-owned banks, with the result that the Indonesian banking system came to be considered an effective market in which competitive principle functioned. How then did quantitative expansion affect banks' behavior? And did it accompany changes in bank lending or asset-investment practices that were conducive to fund raising?

It is said that as part of the state of disorder in the banking sector after the currency crisis, easy loans made the banking sector vulnerable. And it is pointed out that one reason for this vulnerability was the rapid increase in the number of banks in the absence of a sufficiency of skilled human capital and competent screening loan skill. However, such assertions require careful investigation. Against the assumption that the new banks' management systems were inefficient, there is no ground for claiming that banks which had been managed by the government and the Central Bank since 1965 were run effectively. Until the crisis, the Indonesian government had a `no bankruptcy of banks' policy. Such a government policy might be seen as one that encourages moral hazard in banking management. Notably, during and after the crisis, state-owned banks were not closed and but merged, and merger does not necessarily improve effectiveness of management.

Table 6 Number of banks by establishment date

	Number of Bank		Establishment
Sum of all private national banks in 1990 and 1997	188	71	before 1988
		117	after 1988
Number of banks closed by 1997	24	17	before 1988
		7	after 1988
Number of banks as of 1997	164	54	before 1988
		111	after 1988
Number of closure banks after 1997	67	34	before 1988
		33	after 1988
Number of restructured banks after 1997	20	12	before 1988
		8	after 1988
Number of banks as of 1999	91*	39	before 1988
		(27)	Forex Bank
		(12)	Non-forex
		52	after 1988
		(18)	Forex Bank
		(34)	Non-forex

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991–31 December 1999" (CD-ROM).

Note: As of 1999 a number of banks decreased to 91 from 164 in 1997, due to closures of 67 bank, merger of 6 nationalized-banks. A merger of BCA and Bank Risjad Salim International(RSI), and Danamon and 8 nationalized-banks were executed gradually and finished in 2000, so that as of 1999 only 6 banks merger to Bank Danamon were finished.

In this section, the Indonesian banking sector is examined through a six-part categorization of its institutions: state owned banks, regional development banks, private national foreign exchange banks (hereafter, 'forex'), private national non-foreign exchange banks ('non-forex'), joint banks, foreign banks. This examination compares the business performance[13] of state owned banks, forex banks, non-forex banks and joint banks. Findings concerning management and corporate governance in joint banks are expected to be different from those concerning national banks because of the formers' foreign capital holdings. On that basis, it is expected that the criteria for evaluating joint banks will yield the fair indicators of the comparison study.

The categories `forex banks' and 'non-forex banks' are further subdivided into groups in accordance with their foundation years: `before 1988' and `after 1988', in order to determine whether differences in banks' behavior can be attributed to commencement before or after the liberalization of 1988.

After 1988, the rush to establish new banks started. By 1999, 18 of the 45 forex banks were established after 1988, as were 34 of 46 non-forex banks. Between 1990 and 1997 in both periods, there was a total of 188 banks (not including joint banks). Of these, 24 were closed by 1997. Among the 164 banks still in existence in 1997, 67 were closed after the crisis, and the government restructured 20 of them. Table 6 shows the change in the number of banks number.

Table 7 Total Assets of Private National Banks by Establishment Date in 1991, 1994 and 1997

(Mil of Rp)

Establishment	Number of bank as of	Total Assets			
			1991	1994	1997
before 1988	39	all banks	39,462,148	74,466,467	184,094,891
		per bank	769,999	1,438,772	3,503,261
after 1988	52	all banks	3,109,380	9,728,864	29,428,073
		per bank	103,646	249,602	747,345

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

[13] The database of Ekofin Konsulindo is used in the analysis. This database holds all commercial banks', including non-listed banks', half-yearly balance sheets and profit-and-loss assessments from 1991 to 1999. Though there are discontinuities in its records, this database is the only useful one available for a study of the 1990s.

Of the 67 banks closed, 34 were set up before 1988, and 12 of the 20 banks restructured after the crisis were set up before 1988. This shows that `new banks' does not necessarily imply `badly managed banks'. The significant difference between new and old banks was in their sizes. Table 7 shows that the average total asset of old banks in 1991 was 770 billion rupiah *per* bank, while new banks' was 100 billion rupiah *per* bank, or only one-seventh of that of the old banks. Furthermore, comparing forex and non-forex banks on growth of total assets between 1991 and 1997, the forex banks show (Table 8) the bigger growth in total assets *per* bank: these assets increased 8.2 times between 1991 and 1997. Table 8 shows also that during the mid-1990s, the private national banks, including the new private national banks, were at the core of the Indonesian banking sector's expansion.

Table 8 Growth Rate of Total Asset of Private National Banks by Establishment Date in 1991, 1994 and 1997 (Mil of Rp)

	Number of bank as of	Establish -ment date	Total Asset	1991	1994	1997	Compariso n between in 91 and
Forex Bank	27	before 1988	all banks	38,006,174	71,884,693	180,029,945	4.7 times
			per bank	1,407,636	2,662,396	6,667,776	4.7 times
	18	after 1988	all banks	2,458,781	7,166,421	24,065,276	9.8 times
			per bank	163,919	421,554	1,336,960	8.2 times
Non-forex Bank	12	before 1988	all banks	1,455,974	2,581,774	4,064,946	2.8 times
			per bank	132,361	215,148	338,746	2.6 times
	34	after 1988	all banks	650,599	2,562,443	5,362,797	8.2 times
			per bank	43,373	77,650	157,729	3.6 times

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

The following six groupings of banks will be compared: seven state-owned banks[14], 27 old-forex banks, 18 new-forex banks, 12 old-non-forex banks, 34 new-non-forex banks and 31 joint banks. The differences in management across the six groupings will be examined from the perspective of asset structure. But before that examination, the difference in scale among the groups is worth noting. Table-9 shows the percentage of

[14] The seven state-owned banks are Bank Negara Indonesia (BNI), Bank Rakyat Indonesia (BRI), the State Saving Bank (BTN), and the predecessors of Bank Mandiri: Bank Bumi Daya (BBD), Bank Dagang Negara (BDN), Bank Expor Impor (Bank Exim) and Indonesia development bank (Bapindo).

assets of each bank in the six groupings against the total assets of all commercial banks. State-owned banks and old forex banks together commanded around 80% of total assets of all commercial banks. Thus it must be understood that the behavior of both banks types has impacted upon the banking sector as a whole.

Table9 Total Assets by Group of Banks* (%)

	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99
State owned bank**	63.0	62.1	59.2	54.7	50.5	46.1	43.2	47.5	46.4
Old forex bank	22.6	23.0	24.8	27.7	30.5	35.0	33.8	31.9	31.7
New forex bank	1.5	1.6	2.0	2.8	3.1	3.5	4.5	4.0	4.2
Old non-forex bank	0.9	1.0	1.0	1.0	1.0	1.0	0.8	0.9	0.9
New non-forex bank	0.4	0.5	0.8	1.0	1.1	1.2	1.0	1.1	0.9
Joint Bank	5.2	5.6	5.8	6.5	6.8	6.6	7.8	8.2	5.5

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

Note* : Ratio of each group bank's total assets to all commercial banks' total assets, including regional development banks and foreign banks.

Note** : Until 1988, state owned bank consisted of seven banks: Bapindo, BBD, BDN, EXIM, BNI, BRI, BTN. In 1999. Currently there are four state owned banks: Mandiri, BNI, BRI, BTN.

3-1. Financial and Management Indicators by Bank Group

A sound banking system consists of banks that have high profitability and adequate capital (Greuning *at el* [2000:76]).

The following is an examination of the basic indicators of profitability, capital, and risk management. 'Profitability' indicates banks' competitiveness and quality of management, 'sufficiency of capital' indicates banks' safety and soundness, and `risk management' is the most important feature of the lending practices of banks.

(1) Return on Assets [ROA]: profits / total assets

Return on Assets is a ratio of profit-to-total-asset, an important indicator of a company's comprehensive profitability (Table-10). Comparing the average ROA of banks in the six groupings between 1991 and 1996, the highest average is the 4.3% of the old-non-forex banks. The lowest is the 0.7% of the state-owned banks. State-owned banks' ROA was

less than 1% throughout the 1990s. This reveals that the state-owned banks' profitability was low in proportion to their total assets. The new forex banks' was lower still at 1.0%, whereas both the old-forex banks' and the new-non-forex banks' stood at 1.2 %. Joint banks' was at 1.8%.

Table 10 ROA (%)

	Average 91-96	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99
State owned bank	0.7	0.51	0.43	0.51	0.75	0.79	0.93	0.44	-79.6	-18.9
Old forex bank	1.2	1.16	1.09	1.10	1.19	1.28	1.16	1.28	-24.9	-20.3
New forex bank	1.0	0.82	1.16	0.98	0.92	1.02	0.92	0.75	-38.6	-13.4
Old non forex bank	4.3	4.01	4.38	4.12	4.23	4.61	4.17	4.17	-119.1	-68.6
New non forex bank	1.2	1.12	1.79	1.52	1.39	0.81	0.40	1.47	-7.7	-2.4
Joint bank	1.8	2.39	2.02	1.77	1.12	1.58	1.67	0.91	-14.4	0.3
Average	2.0	2.00	2.17	2.00	1.92	2.02	1.85	1.81	-56.9	-24.7

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

Table 11 ROE (%)

	Average 91-96	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99
State owned bank	10.4	12.6	7.2	9.4	9.7	11.9	11.9	6.8	110.2	448.1
Old forex bank	12.0	11.5	10.9	12.1	11.3	13.4	12.6	9.8	41.7	-12.6
New forex bank	7.1	4.8	6.5	6.9	7.2	8.6	8.7	5.2	69.5	-41.5
Old non forex bank	9.8	8.4	12.7	10.0	11.0	10.1	6.7	7.3	-41.1	-65.7
New non forex bank	5.2	3.3	5.8	7.1	8.0	4.5	2.5	7.2	-188.8	-102.7
Joint bank	10.6	10.5	12.2	11.1	7.7	11.1	11.3	5.0	132.2	44.3
Average	11.0	10.2	11.1	11.3	11.0	11.9	10.7	8.3	24.7	54.0

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

Okuda [2000: 199-208] compared the ROA of Thai and Philippine banks across three groupings: upper class bank, middle-class bank, and lower-class bank. According to that study, the Philippine upper class banks' ROA in 1991 and 1994 was 2.9% and 2.3%, the middle-class banks' 3.0% and 2.2%, and the lower-class banks' 3.2% and 3.2%. The Thai upper-class banks' was 1.5% and 2.5%, the middle-class banks' 0.8% and 1.9%, the lower-class banks' 0.6% and 1.1%. Among Indonesian banks, only the old non-forex banks' and the joint banks' profitability was higher than the Thai and Philippine banks'; the rest were lower. On the whole, profitability during the latter part of the 1990s tended to be lower than it was during the early years of that decade.

Table12 Profitability Ratio (Net Interest Profit/Earning Assets) (%)

	Average 91-96	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99
State owned bank	2.5	1.9	1.5	2.5	3.3	3.0	2.7	2.4	-5.2	-6.0
Old forex bank	3.3	2.3	3.9	3.6	3.6	3.2	3.2	3.3	-12.1	-5.1
New forex bank	4.3	4.5	5.6	4.0	4.1	4.2	3.6	-0.3	-19.1	-13.8
Old non forex bank	5.6	1.1	6.6	7.3	7.6	5.5	5.5	6.5	10.4	6.6
New non forex bank	4.9	1.7	8.0	5.9	5.3	4.6	4.1	6.4	6.1	3.7
Joint bank	3.7	5.0	4.3	3.5	2.8	3.0	3.3	2.6	4.3	4.2
Average	4.9	3.3	6.0	5.4	5.3	4.7	4.5	4.2	-3.1	-2.1

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

(2) Return of Equity [ROE]: net profits/ equity

Return on Equity is as much a basic indicator of a bank's profitability as is ROA (Table-11). ROE is the ratio of net profit to capital. It is one of the indicators of profitability from the shareholder's point of view. Between 1991 and 1996 the average ROE of old-forex banks was the highest at 12%. Both state-owned banks and joint banks were at more than 10%, and the lowest, the new non-forex banks', was at 5.2%. This was so because the state-owned banks' and the forex banks' capital was rather small, while the new non-forex banks' was large. That is, the new-non-forex banks' capital ratio (capital divided by total asset) was at an average of 33.5% from 1991 to 1996. This was higher than the state-owned banks' capital ratio of 4%.

(3) Profitability (net interest profits/earning assets)

Banking profitability from the staple business, lending, can be represented as the ratio of `net interest profit from earnings assets' to `total earnings assets' (Table-12). The state-owned banks' profitability was the lowest. The old non-forex banks' rose after 1992. Next to that the new-forex banks' was also high. However, the new-forex banks' net interest profit was already heading towards the negative in 1997. By 1998 three groups' figures – the state-owned banks', the old-forex and the new-forex banks' – were in the negative, while non-forex banks still kept a rather high level. This difference is accounted for in terms of the difference in the volume of foreign currency assets and liabilities. That difference in volume shows that the impact of devaluation was the most severe on the state-owned banks and on the forex banks.

(4) Loan-to-Deposit Ratio [LDR]: total outstanding credit/total deposit

LDR is a ratio of total lending to total deposit (Table-13). From the profitability perspective, high LDR is preferable, but from the risk perspective, too much lending against funding capacity or deposit is not desirable. State-owned banks' LDR was as high as 106.6% on average. Joint banks' was the highest at 164.3%. On the other hand, old-forex banks' and new-forex banks' LDRs were rather low at 78.1% and 67.2 respectively, as were old-non-forex banks' and new-non-forex banks' at 56.5% and 57.5%. Especially during the first half of the 1990s, the non-forex banks' LDR was very low at 30-40%.

Table 13 LDR (%)

	Average 91-96	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99
State owned bank	106.6	135.1	124.7	101.9	91.0	91.4	95.5	101.7	130.6	124.5
Old forex bank	78.1	81.2	73.8	73.7	82.7	79.5	77.6	81.5	47.4	22.1
New forex bank	67.2	53.6	65.7	65.1	76.1	73.3	69.4	82.6	-70.5	28.2
Old non forex bank	56.5	31.9	41.6	56.2	68.4	71.8	69.2	69.1	391.4	34.0
New non forex bank	57.5	40.1	44.9	56.4	67.3	67.1	68.9	69.7	38.1	35.4
Joint bank	164.3	150.9	164.5	165.6	156.5	178.9	169.6	200.5	288.6	88.7
Average	106.0	98.6	103.0	103.8	108.4	112.4	110.0	121.0	165.1	66.6

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

Table 14 Expenditure Ratio (%)

	Average 91-96	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99
State owned bank	38.9	46.1	44.3	36.2	31.2	35.2	40.3	43.5	-18.1	-25.1
Old forex bank	34.6	34.4	35.7	36.3	35.3	34.4	31.3	28.4	-6.4	-18.9
New forex bank	35.6	36.4	33.6	39.8	34.2	32.8	36.7	-485.7	-5.7	-10.6
Old non forex bank	35.5	36.2	32.3	29.9	33.1	42.5	39.1	38.9	20.5	30.9
New non forex bank	28.7	21.8	27.2	27.8	28.7	30.7	35.7	28.4	30.8	44.9
Joint bank	17.8	13.1	15.3	19.5	22.2	18.5	18.4	18.1	13.0	15.7
Average	38.2	37.6	37.7	37.9	36.9	38.8	40.3	-65.7	6.9	7.4

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

(5) Expenditure Ratio (expense for personnel/ net interest profit)

Ratio of expense for personnel to net interest profit represents management efficiency (Table-14). The state-owned banks' was high at 38.9% on average from 1991 to 1996, while the lowest was the joint banks' at 17.8%. The new-non-forex banks' was in the twenty-percent range, and both the forex-banks' and the old-non-forex banks were in the thirty-percent range. Except the joint banks', all other banks' levels were almost the same.

Table 15 Provision Ratio (%)

	Average 91-96	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99
State owned bank	3.1	3.0	3.2	3.8	3.7	2.4	2.2	2.4	39.1	30.5
Old forex bank	1.5	1.1	1.7	1.7	1.6	1.6	1.6	2.0	35.6	20.9
New forex bank	0.9	0.6	0.9	0.9	0.9	1.2	1.1	2.2	33.9	14.5
Old non forex bank	1.3	0.7	1.3	1.5	1.8	1.3	1.4	1.5	10.5	4.6
New non forex bank	1.6	1.8	1.7	1.2	1.1	1.6	1.9	2.4	18.7	9.0
Joint bank	2.4	2.3	3.0	2.7	2.2	2.0	2.3	3.7	24.6	27.1
Average	2.2	1.9	2.4	2.3	2.3	2.0	2.1	2.8	32.5	21.3

Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial Performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

(6) Provision Ratio (provision/total lending)

Provision ratio to total lending is one of the indicators of risk management (Table15). The state-owned banks' was at 3.1%, and the joint banks' at 2.4%, while both of forex and non-forex banks' were at the low level of 0.9-1.6%. In 1995 and 1996 all banks' figures were falling because in those years default risk tended not to be measured against rapid increase in lending. After the crisis, the state-owned banks' provisional ratio became high at 39.1%, and the other banks' also rose to level at 20-30%. Because of the crisis, the problem of non-performing loan came to the surface, and all banks were required to accumulate provision against default risk.

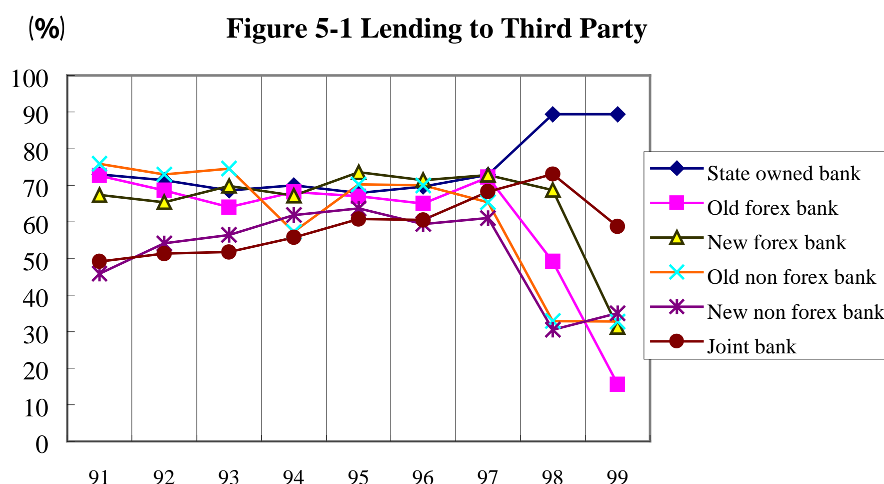
3-2. Asset Portfolio and Funding by Banking Groups

(1) Changes in Asset Portfolio

One of the most important functions in banking is the intermediary. Banks collect short-term funds and lend them to primary borrowers through several mechanisms like

conversion of term, reduction of risk, reduction of administrative costs, and so on. This section, of which the main concern is the bank-asset portfolio, will investigate to which sectors banks tend to lend and how they invest their funds other than as loans. Several factors – such as the level of deposits with other banks, the value of outstanding marketable-securities holding, the existence of loans to related companies, the volume of third-party loans, and the level of investment in stocks in relation to total assets – are used as measures of analysis.

Figure 5 Changes in Asset portfolio,1991～1999*



After the crisis, the large volume of group lending was criticized. Figure 5-1 shows the ratio of third party lending[15] to total assets. In the early 1990s, bank lending volume registered on two levels: new non-forex banks' and joint banks' ratios were at around 50%, and other banks' at 70%. Before the crisis almost all banks were on the same level at around 65-75%. However, after the crisis, lending behavior towards third parties differentiated as two trends. The state-owned banks' level was at 72.9% in 1997 but increased to 89.4% in 1998. The joint banks' also increased to 73% in 1998 from

[15] The Debtor and Fund Resource Bank recognized two categories: `related company' and `third party'. According to the Indonesian Accounting Association's Standard Finance Accounting No 7 – Peryataan Standar Akuntansim Keuangan No.7, (Ikatan Akuntan Indonesia (1999) – a `related company' is a 'subsidiary' if a bank is its dominant stake-holder owning more than 50% of its shares, or it is an 'affiliate' with which a bank cooperates in matters to do with capital or human capital. A `third party' is any entity other than a related company.

68.3% in 1997. On the other hand, other banks reduced third-party lending in 1998: old-forex banks' reduced to 49.2% from 72.2% and old non-forex banks' reduced by half from 65.4% to 32.9%.

Figure 5-2 Lending to the Related Company

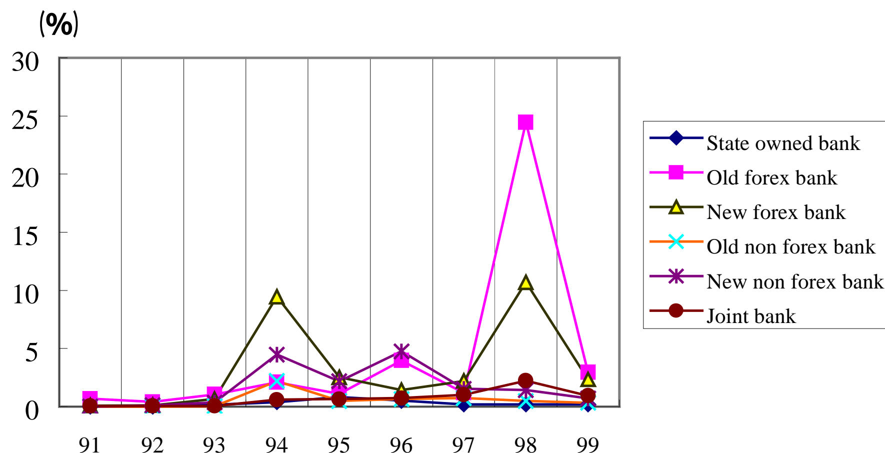
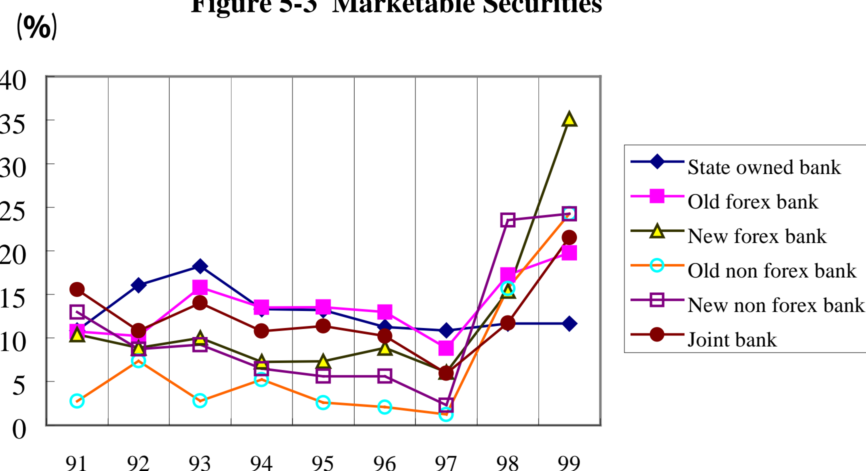


Figure 5-3 Marketable Securities



Alongside the decrease in their third-party lending, old forex-banks increased lending to related companies from 1.2% to 24.4% (Figure5-2), while old non-forex banks increased marketable securities holding and deposits with other banks (Figure 5-3, 5-5). During the 1990s both these banking groups kept stable levels in their marketable securities holdings, but after the crisis all banks except state-owned banks increased their marketable securities stake in response to the very tight monetary policy. In mid-1998, since the interest rate on the one-month Central Bank Certificate (Sertifikat Bank

Indonesia: SBI) rose to around 70% *per annum*, banks shifted their investment from lending to safety assets such as SBI.

Figure 5-4 Stock Investment

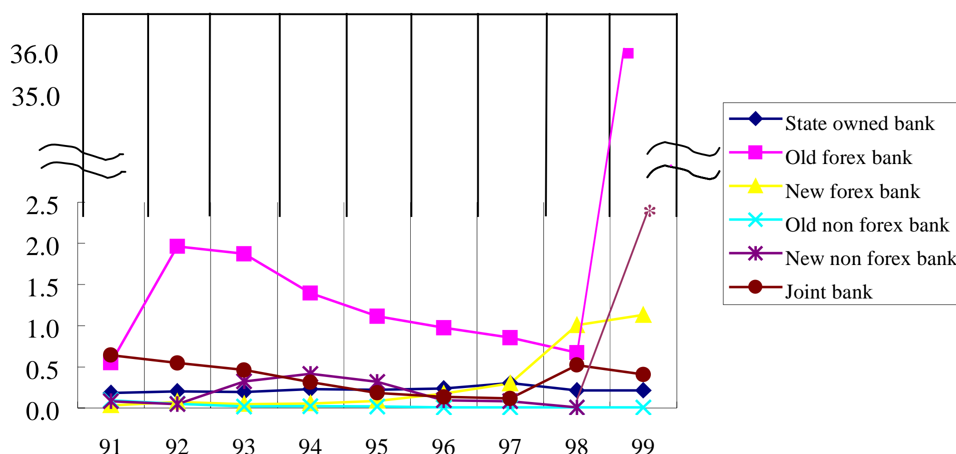
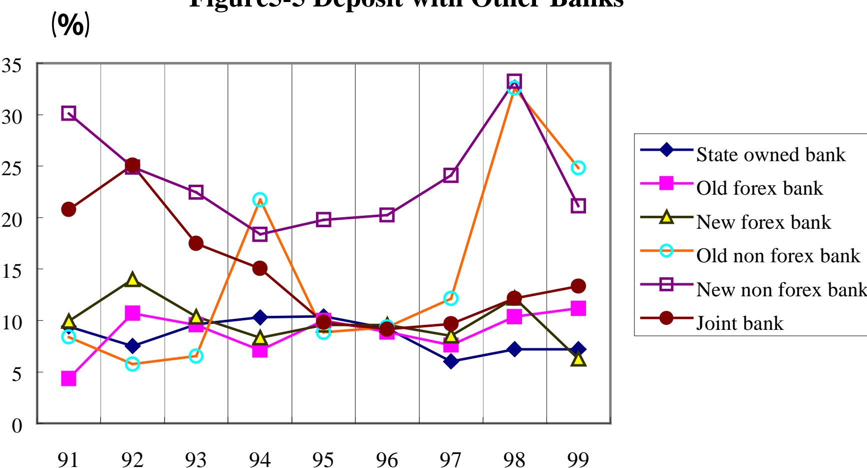


Figure5-5 Deposit with Other Banks



Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

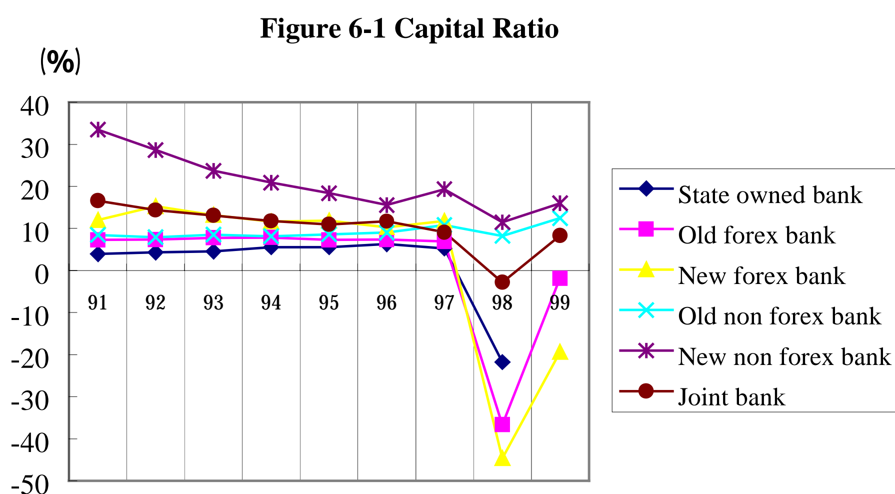
Note: Indicators are ratio to total assets.

Old forex banks, which rapidly increased lending to related companies in 1998, decreased to 3% in 1999, and at the same time, increased investment in stock to 35.2% (Figure5-4). New non-forex banks deposited a certain amount of funds, around 20%-30% of total assets, to other banks. This level was higher than other banks'. Joint banks

deposited around 20% of total assets to other banks, and then reduced it to 10% of total assets (Figure5-5). After the crisis almost all banks increased deposits with other banks. Both old and new non-forex banks increased the level of these deposits to 33%. These changes were expedited by high interest rates and by banks' preferring better safety and more stable investment to the risks of lending.

Figure 6　Changes in liability and equity by Group of banks, 1991～1999*

Figure 6-1 Capital Ratio



(2) Changes in capital ratio

Capital ratio, which is capital divided by total asset (Figure-6-1), in state-owned banks was at 4%-5%, in old forex and old non-forex bank at around 7%, while in new forex and joint bans at 12%, new non-forex banks it remained a high level at more than 20%. After the crisis, all banks' capital was heavily damaged. The state-owned banks' and the forex bank's capital was particularly seriously reduced. Increase in non-performing loans and the deep devaluation of the rupiah resulted in negative capital. On the other hand, old and new non-forex banks kept their capital, thanks to the low levels of their asset and liability in foreign currency.

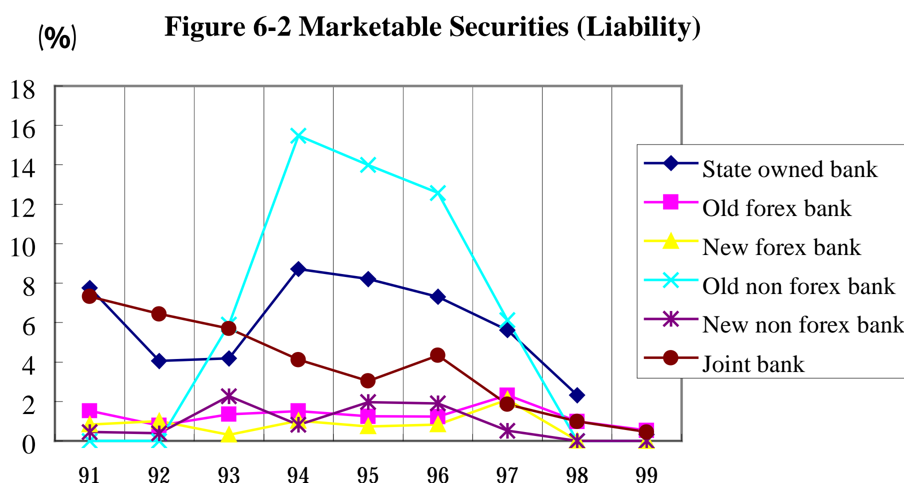
(3) How banks raise funds

Ratio of issuance of securities, third-party funds (which exclude funds from related companies), time deposits from related companies, and borrowing to total liability are

examined with the purpose of isolating the major ways in which banks raise funds. Old non-forex banks and state-owned banks have a high ratio of funds raised by issuance of securities after 1994 (Figure 6-2). The ratio of funds raised by third-parties as main resource, joint banks' at around 20% and state-owned banks' at 50-60% (Figure 6-3).

Borrowing, another measure of raising funds, was kept at 50% by the joint banks, and at around 30% (also a high level) by the state-owned bank. These high borrowing ratios show that these banks commanded high levels of trust on the money market. Creditworthiness is an important element of the capacity to raise funds. In that sense, the state-owned banks' average ratio of 31.5% and the joint banks' ratio of 35.4%, much higher than the old non-forex banks' of 7.1% and the old forex banks' of 8%, reveal that the market considered the state-owned banks and the joint banks more creditworthy than the other banks.

Figure 6-2 Marketable Securities (Liability)



The ratio of time deposit from related companies to total liabilities (Figure-6-5) increased in the new forex banks and in the new non-forex banks after 1994. It is said that a strong relationship between banks and related companies is evident in group lending. However, in the light of published data, it is said also that banks play some role in collecting funds from related companies and in investing them. That role is peculiar to new banks.

Figure 6-3Funds from the Third Party

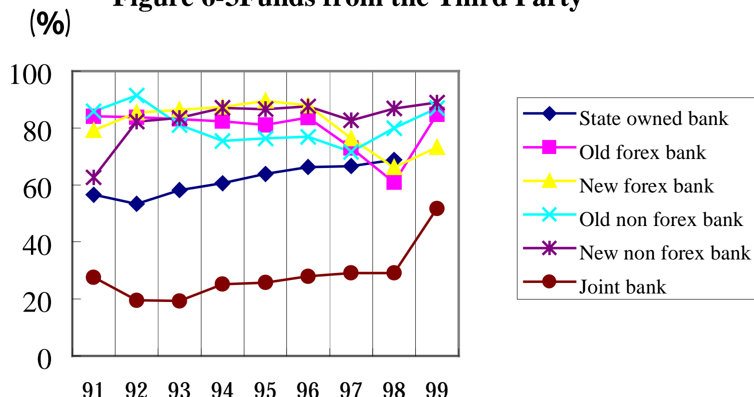


Figure 6-4 Borrowing

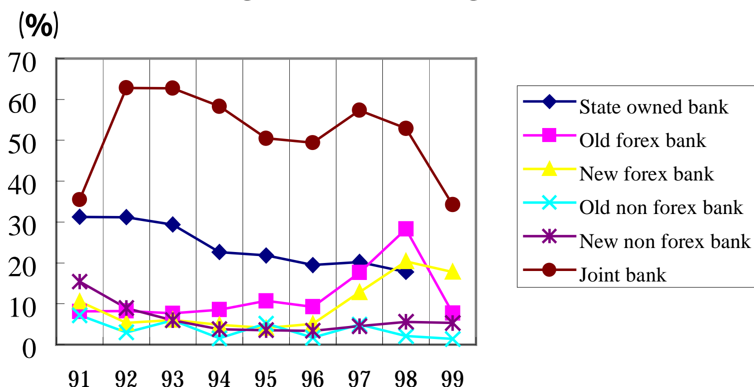
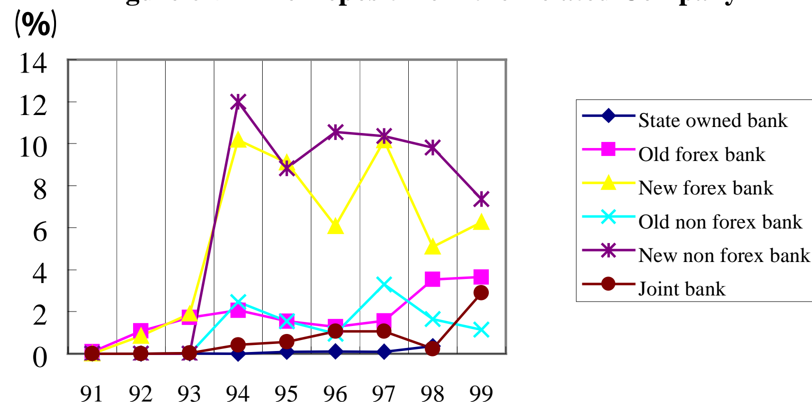


Figure 6-5 Time Deposit from the Related Company



Source: PT Ekofin Konsulindo, "Indonesian Banking Indicator and Financial performance 31 December 1991 - 31 December 1999"(CD-ROM), Jakarta, 2000.

Note*: Capital ratio is a ratio of equity capital to total assets, not CAR. Liability indicator is a ratio total liability.

3-4. Summary of Analysis in Financial Indicator

When banks are organized in accordance with their establishment dates as `before' and `after' 1988, the number of the banks that failed during the crisis is almost same in two groups; before and after 1988. Thus it is difficult to assert that that there is a clear correlation between the deterioration of banking management and a bank's `establishment' dates. Differences in the size of banks' assets provide better scope for discerning correlations. The average total asset of new banks is only one-seventh of that of the old banks. It is can be said that small banks proliferated after 1988. And new banks had rather larger holdings of equity capital in proportion to their total assets than did the old banks: the new non-forex banks' capital ratio was kept at more that 20%. However, large equity capital does not necessarily imply sound management. Where deposits from related companies' account for the large percentage of total liabilities, there may still be a lack of ability to absorb third-party funds. Difference in size shows little disparity between old and new banks, but a distinct disparity is contingent upon a bank's being a forex bank or non-forex bank.

As already mentioned at the begging of this section, 80% of the commercial banking sector in Indonesia is dominated by state-owned banks and old forex banks. These banks, which represent the Indonesian banking sector, have similar characteristics such as large asset holdings, and in comparison with other banks, relatively small equity capital and relatively low profitability. As the state-owned banks' ratio of cost is the highest, their management effectiveness is lower than other banks'. Nevertheless, both state-owned and old forex banks keep high loan-deposit ratios. These factors reveal that state-owned banks, which have been the center of the Indonesian financial system, and old forex banks, which have complemented state-owned banks, have had central roles as intermediaries. There are some indications that over-lending is a normal situation in Indonesia (Okuda, 2000:223). Although the joint banks, where the average LDR is 164%, are exceptions, even state-owned banks have an LDR of around 100%, and the others are not far below at 100%. The data in this section suggests that over-lending is not a remarkable tendency.

When a bank disburses a loan, a risk-management assessment must accompany it. However, the low provision rate shows that risk management was not widely practiced before the crisis. When awareness of the risk associated with lending was low, state-owned banks prepared higher relative provisions than did other banks. Because it was pointed out that state-owned banks' credit had become non-performing since the beginning of the 1990s, state-owned banks' provision was set at a higher level.

During the 1990s, the addition of the new forex banks to the existing state-owned and old forex banks contributed to the expansion of the Indonesian banking sector. New forex banks had been expanding since 1994. They are characterized by low ROA and ROE, but by high capital ratio compared to that of state-owned and old forex banks. Their profitability is also higher, but their provision ratio is the lowest. This shows that risk management did not accompany the rapid process of expansion.

Because non-forex banks service small companies or individuals with smaller credit demand, their function might be different from that of state-owned and forex banks. The features of non-forex banks, both old and new, are large equity capital and high profitability. Indicators show them to be `excellent` banks. Although the number of non-forex banks accounts for 30% of the total number of banks, the total asset of both old and new non-forex bank accounts for only 2% of total assets of all commercial banks. They are very small banks (Table-9). Their ratio of third-party fund to total liability is around 80%, but their LDR is low, and their portion of deposit to other banks is large. There is a big difference in the measure of investment between them and the state-owned or forex banks. New non-forex banks have an especially high ratio of time deposit from related companies, and a low ratio of third-party lending. Therefore they have little intermediary function.

Before the crisis, banks' group lending mounted to 70%-90% of total lending.[16] This large group lending become a big problems in the Indonesian banking sector, but according to published data, almost 70%-80% of bank lending is third-party lending. However, during the crisis many banks reduced their third-party loans and increased credit to related companies. The forex banks in particular rapidly (though temporarily) increased loans to related companies. A portion which decreased in third-party lending was divided not only to related companies but also to safety assets like SBI or to deposit

[16] 29 September, 1998, *Jakarta Post*

to other banks. So except for a short period in 1998, it is difficult to point to a plethora of group lending[17].

On the one hand private banks changed their lending behavior to cope with the crisis, and on the other hand state owned banks increased third-party credit. This reveals that after the crisis the role of the state-owned banks became big, and there was even the temporary phenomenon of a return to pre-liberalization times. State-owned banks, which have regained the dominant position, have a low profitability and a high expenditure ratio compared with other banks'. Since the current Indonesian banking sector is influenced by the state-owned banks' performance, those banks are well advised to improve the efficiency of their management and to strengthen the soundness of their balance sheets.

Conclusion

This paper examined the development and transformation of the Indonesia financial sector, with particular attention to its banking sector, and it presented the following findings:

Since the formative period of the financial structure at the beginning of the Soeharto era and through to the period of policy-based finance under soaring oil prices, the Indonesian banking system, in which the Central Bank and the state-owned banks had always been the main players, functioned as distributor of government fiscal funds. This situation and the structure were radically altered by the financial reforms of 1983 and 1988. These reforms developed the financial sector, and private national banks became prominent players in the system. On the basis of this, the Indonesian financial system came to be regarded as an effective market modeled on the competitive principle. However, the currency crisis of 1997 damaged bank assets deeply, and many private national banks were closed or nationalized, with the result that state-owned banks regained their dominant position in Indonesian banking sector.

Also examined, in the light of post-1990 financial indicators, were the differences in management and portfolio structure across several groupings of banks. It

[17] As the data used in this section cannot specify the way of banks' appropriation of lending to related companies, it cannot be denied that the data does not reflect the reality of group lending.

was argued that the rush to establish new banks during the second reform in 1988 caused the Indonesian banking system to become fragile. It was noted, however, that on comparing banks in terms of establishment times `before' and `after' 1988, it is difficult to discern a clear correlation between `before' and `after' establishment times and deterioration in the effectiveness of management. Rather, the big discrepancy that was noted between banks is in their total-asset sizes. Some indicators showed that the state-owned banks and the old forex banks controlled around 80% of the total assets of all banks, and that they had a high Loan Deposit Ratio [LDR]. These banks had played a central role in intermediation. Non-forex banks were found to be excellent banks on the grounds that they have a high capital ratio and a high profit ratio. Nevertheless, they are very small banks and contribute little in the way of intermediary function.

The large volume of group lending constituted a very big problem in Indonesia. However, on the evidence of published data, most of that lending is in the form of third-party loans. After the crisis banks increased lending to their related companies and shifted their investment to safety assets. Many shifted funds back to state-owned banks or to foreign banks in a 'flight to safety'. Thus the state-owned banks regained their main-player positions in the banking sector.

Disorder in the financial sector affects its national economy. Since non-performing loans aggravate an already-harmed economy, it is difficult to settle the problem instantly. However, the resolution of the non-performing loans problem and the resumption of extending credit to the real sector are the necessary preconditions to economic recover. In the present time, the Indonesian banking sector is in a process of restructuring. First, it needs to sweep away the damage done by the macro-shock of the currency crisis. The crisis identified some inherent systemic problems in the implementation of prudential regulations, in supervising capability and in the accounting and legal system. These problems must be resolved, at the same time the conventional financial system has to be reviewed with a view to bringing it in line with the globalization.

The Indonesian financial sector continues to be beset by problems. Re-capitalization at the end of 2000 provided urgently-needed remediation. The main issue of 2001 was the self-reliant reorganization by banks themselves. However, 2001 saw also the extending of credit that remained inactive. One of the causes of this was an IMF-

imposed condition that constrained banks' lending behavior: they faced closure or merger if their CAR failed to reach 8% by the end of 2001. Indeed, some banks were closed or merged at the end of 2001.

These closures and mergers were aimed to improve banking soundness. Four state-owned banks were merged to form a large bank, the Bank Mandiri, which dominated 30% of total assets of all commercial banks. However, its effect on the Indonesian banking sector is yet to be assessed. Although the banking sector was significantly changed by closures and mergers, it is too early to evaluate the success of this action.

The matters that must be solved are obvious. They include the need to improve the effectiveness of day-to-day banking practice, the need to acquire competent risk-assessment and loan screening skills, the need to maintain sound balance sheets, and the need to improve transparency. The importance of accountability and transparency of management are now gaining recognition. The onus of making continuous effort to restructure is not upon banks only but also upon corporations and the government.

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