

Report No. 5501-IND

# Indonesia Policies and Prospects for Long Term Financial Development

July 10, 1985

East Asia and Pacific Regional Office

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CURRENCY EQUIVALENTS

Before November 15, 1978

US\$1.00 = Rp. 415

Annual Averages 1979-84

1979

US\$1.00 = Rp. 623

1980

US\$1.00 = Rp. 627

1981

US\$1.00 = Rp. 632

1982

US\$1.00 = Rp. 661

1983

US\$1.00 = Rp. 909 <sup>/1</sup>

1984

US\$1.00 = Rp. 1,026

July 9, 1985

US\$1.00 = Rp. 1,118

FISCAL YEAR

Government

-

April 1 to March 31

Bank Indonesia

-

April 1 to March 31

State Banks

-

January 1 to December 31

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<sup>/1</sup> On March 30, 1983 the Rupiah was devalued from US\$1.00 = Rp. 703 to US\$1.00 = Rp. 970.

**TITLE : INDONESIA: POLICIES AND PROSPECTS FOR LONG TERM FINANCIAL DEVELOPMENT**

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**ABSTRACT :** This report examines developments in the financial sector in Indonesia, particularly since the financial sector reform of June 1983; analyzes selected issues with regard to monetary management and credit policies, cost and availability of long-term credit and institutional development in the financial sector; and suggests policy and institutional recommendations aimed at facilitating the evolution of an efficient financial system over the medium term.

# INDONESIA

## POLICIES AND PROSPECTS FOR LONG TERM FINANCIAL DEVELOPMENT

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**MAP**

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This report was prepared by a mission comprising Para Suriyaarachchi (mission leader, RSI), Frederick Kilby (RSI), James Hanson (INDFD), Khalid Siraj (AEPID), J. Tata and Toshio Konishi (IFC-CCMD) and Robert Coleman (consultant). The field work by the main mission was undertaken in May-June 1984 and by the consultant in July 1984. A draft of the report was discussed with the Government in May 1985.

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List of Abbreviations and Acronyms

ASKRINDO	Asuransi Kredit Indonesia (Indonesian Credit Insurance Corporation)
BAHANA	P.T. Bahana Pembinaan Usaha
BAPEPAM	Badan Pengembangan Pasar Modal (Capital Market Executive Agency)
BAPINDO	Bank Pembangunan Indonesia (Development Bank of Indonesia)
BI	Bank Indonesia
BIMAS	Bimbingan Masal Swasembada Bahan Makanan (Mass Agricultural Intensification Program)
BTN	Bank Tabungan Negara (National Savings Bank)
BULOG	Badan Urusan Logistik (State Logistics Agency)
CDs	Certificates of Deposits
DMBs	Deposit Money Banks
IFC	International Finance Corporation
IMF	International Monetary Fund
KIK	Kredit Investasi Kecil (Small Investment Credit)
KMKP	Kredit Modal Kerja Permanen (Permanent Working Capital Credit)
MIS	Management Information System
MMS	Money Market Securities
NBFIs	Non-Bank Financial Institutions
PDFCI	Private Development Finance Company of Indonesia
PERUMTEL	Perusahaan Umum Telekomunikasi (State Telephone Corporation)
RDBs	Regional Development Banks
SBI	Bank Indonesia Sertifikat (Bank Indonesia Certificates)
TABANAS	Tabungan Nasional (Small Savings)
UPPINDO	Usaha Pembiayaan Pembangunan Indonesia (Institution providing venture capital)

## OVERVIEW

1. This report examines developments in the financial sector in Indonesia since the June 1983 reform, analyzes key issues which have emerged since that time, and suggests policy and institutional recommendations to facilitate the further development of the financial system over the medium term. In particular, the report focuses on the following aspects: monetary programming and coordination of monetary and fiscal policies, the role of priority credit programs, financing of public enterprises, cost of credit and efficiency of state banks, term lending and the role of development banks, and measures to revive the capital market.

2. The report argues that Indonesia's open capital account imposes certain limitations on the extent to which the authorities can influence domestic interest rates, investment and output levels through credit policies. Given the open capital account, excessive credit expansion by Bank Indonesia (BI) could lead rapidly to a loss of foreign exchange reserves and undermine the external payments position. Given these constraints, BI will need to monitor closely changes in the Government's fiscal position and carefully manage the growth of its direct and indirect credits through effective monetary programming. On the other hand, if Government deposits with BI were to increase more rapidly than anticipated, this could reduce the growth of reserve money and put pressure on banks' liquidity and domestic deposit and lending rates. Thus, BI needs to stand ready to take offsetting actions and develop additional instruments for injecting liquidity into the banking system when needed.

3. The report also examines the implications of the changing macroeconomic environment for the management of credit policies. It takes the view that the extent to which BI can prudently expand liquidity credits for funding "priority" programs will be limited in the future. It therefore counsels against the expansion of existing priority programs and/or the creation of new programs over the medium term. It also suggests that the existing priority programs be reviewed carefully with a view to limiting preferential financing to carefully defined and monitorable programs, while reducing credit subsidies by raising the final lending rates.

4. Another credit policy issue relates to bank financing of public enterprises. The financial position of many public enterprises is apparently weak. The authorities therefore need to monitor the growth of public enterprise borrowing from the banking system very carefully both to ensure that only enterprises with projects which can be funded on commercial terms borrow from the banking system, and that public enterprise borrowing does not crowd out the private sector from having adequate access to bank credit.

5. Although the June 1983 reform has contributed positively to the development of the Indonesian financial system in many respects, it has also led to a sharp increase in domestic real lending rates and possibly affected adversely the flow of long-term loans through the state banks, the development banks and the capital market. The report argues that, given the constraints mentioned above, there is little scope for the Government to bring down domestic lending rates through monetary policy actions. However,

intermediation costs of state banks are quite high in Indonesia; and reductions in such costs provide an important means of lowering domestic interest rates independently of developments abroad. The report also suggests ways and means of reducing the cost of funds of banks, and encouraging banks to increase term lending, for example by moving to variable rates.

6. The report argues that there is a strong case for retaining the development banks as an additional source of term finance, and for maintaining their presently specialized character. However, it is essential to improve the portfolio quality of development banks, strengthen their institutional capabilities and make them financially viable through financial restructuring and substantial infusions of government capital before they can become effective agents of development.

7. The capital market is a potentially important source of finance to investors in the longer term. The report identifies a number of steps to help expand the capital market. The equalization of tax treatment of earnings from bonds vis-a-vis time deposits is perhaps the most important short-term measure that may help to increase activity levels in the capital market.

## SUMMARY AND CONCLUSIONS

### A. Introduction

(i) The Indonesian financial system is still at an early stage of development. It is dominated by the banking system, which comprises Bank Indonesia (the central bank), five state commercial banks, sixty nine private banks providing mainly short-term credits, and development banks which are an important source of long-term credit. The capital market is still very simple and limited in scope.

### B. Financial Sector Reform and Subsequent Developments

(ii) Until recently the Indonesian financial system was tightly controlled by the authorities. The Government channeled its financial savings into the banking system through low-interest liquidity credits (refinance facilities) by Bank Indonesia (BI) in order to achieve a variety of development objectives. BI in turn set deposit and lending rates of state banks and detailed credit ceilings for all banks, and guided the allocation of credit through the liquidity credit mechanism. However, as oil prices weakened in 1982/83 and the Government's financial position came under pressure, the authorities introduced a major reform of the financial sector in June 1983 to stimulate private financial savings, improve resource allocation, and reduce the dependence of the banking system on BI liquidity credits. Consequently the state banks are now free to set their deposit rates; credit ceilings have been eliminated for all banks; and the number of special priority programs qualifying for (and the state banks' access to) new BI liquidity credits has been substantially reduced.

(iii) These reforms have had a dramatic impact on the banking system. Nominal (and real) deposit rates paid by state banks have increased sharply; and there has been a rapid increase in bank deposits, particularly time deposits, of state banks in the post-June 1983 period. Given these changes, the cost of funds and lending rates of state banks have also increased sharply. Nominal lending rates of state banks on non-priority (general) loans have risen from a range of 13-13.5% earlier to 18% for term loans and 21-24% for working capital, representing real lending rates of around 9-15%. Real lending rates of private banks are even higher, ranging from 15-19% p.a. With the removal of credit ceilings, private banks have increased their share of bank credit from 11% in June 1983 to 16% in December 1984, and an active inter-bank money market has also emerged.

(iv) These changes have been on the whole beneficial to the long-term development of the financial system, although a number of concerns have emerged. The first and the most important is the potentially adverse impact of the sharp rise in real interest rates on investment activity. Second, the recent changes have had an adverse impact on the cost and availability of state banks' term loans. Third, the rise in the cost of funds and the reduction of BI's liquidity credits have also created funding problems for the development banks. Fourth, the rise in deposit rates and the favorable tax treatment of bank deposits have adversely affected the development of the capital market. Thus, the authorities face important challenges in regard to

managing monetary and credit policy in the medium term, increasing the supply of term loans for investment, promoting institutional development in the banking system, and reviving the capital market. These issues and possible strategies to deal with them form the main focus of this report.

### C. Monetary Programming and Credit Policies

(v) Indonesia's open capital account imposes certain limitations on the extent to which the authorities can influence domestic interest rates, investment and output levels through credit policies. Firstly, given the open capital account, domestic deposit rates are largely determined by international interest rates and domestic inflation and exchange rate expectations. These deposit rates and relatively high intermediation costs, in turn, determine domestic lending rates. The authorities could, through the conduct of prudent monetary and fiscal policies, lower domestic inflation and thereby exert some influence on the formation of expectations with regard to exchange rate risks and the margin by which domestic deposit rates exceed the floor level set by international deposit rates. However, this influence is likely to be limited to the extent that there are uncertainties with regard to future oil price movements. Indeed; in the past year, the uncertain outlook for oil prices and associated expectations of exchange rate changes vis-a-vis the US Dollar have been important factors contributing to the high level of nominal and real deposit and lending rates in Indonesia. Secondly, given the open capital account, a rapid expansion of Bank Indonesia credits (in excess of the rate of growth of government deposits with Bank Indonesia and monetary base requirements) is likely to lead to a loss of foreign exchange reserves more than it affects investment and output levels.

(vi) Given these constraints, Bank Indonesia will need to monitor closely changes in the Government's fiscal position and carefully manage the growth of its direct and indirect credits through effective monetary programming. This also means that the extent to which Bank Indonesia can prudently expand credit to finance special credit programs without jeopardizing its monetary, inflation and foreign exchange reserve targets is limited. Over the medium term, the Government's fiscal position is expected to remain tight. Projections made by World Bank staff indicate that, given the Government's inflation and growth targets and after allowing for some increase in foreign exchange reserves, Bank Indonesia can increase its credits by between Rp. 2.4 trillion and Rp. 4.4 trillion during 1984-88, depending on the level of government deposits with Bank Indonesia. The overall demand for Bank Indonesia priority credits during 1984-88 is projected by the mission at about Rp. 5.9 trillion. (This forecast assumes that the implementation of priority programs financed by Bank Indonesia credits will be substantially slower than projected in REPELITA IV, particularly in the tree crop sector, and that no new priority programs will be started in the in the next few years.) These projections show that, if government deposits with Bank Indonesia remain at their December 1984 levels in nominal terms, Bank Indonesia will be unable to fund prudently the projected demand for priority credits from 1986 onwards. Even under the assumption that government deposits

(in nominal terms) with Bank Indonesia will continue to increase at the rate of domestic inflation over the medium term, the availability of Bank Indonesia credits (consistent with BI's monetary, inflation and reserves targets) is likely to fall short of the projected credit demand from existing priority programs by 1987. Thus, these projections counsel against the introduction of any new priority credit programs and suggest the need for a careful review of existing programs.

(vii) A reexamination of priority programs can also be justified on other grounds. These programs at present receive large credit subsidies. Projections by World Bank staff suggest that credit subsidies for ongoing priority programs (including subsidies on new credits and on the existing stock of liquidity credits) over the next 4 fiscal years are likely to be around Rp. 500 billion annually. This is a substantial amount relative to the Government's non-oil tax revenues (estimated at Rp. 5.5 trillion in 1984/85). Furthermore, to the extent that these programs are given preferential access to credit (through subsidized liquidity credits), they will preempt resources from alternative activities and investments and could lead to a misallocation of resources. It is important therefore that the priority programs which are considered for preferential financing be limited to carefully defined and monitorable programs, that credit subsidies be targeted more carefully, and that the scale of subsidies for these programs be reduced progressively.

(viii) In addition, the financing mechanisms for priority programs will need to be reviewed both to reduce subsidies and to achieve other desired objectives. As a medium term policy goal, the authorities should try to reduce the dependence of these programs on BI credits and to encourage banks to assume greater responsibility for financing these programs. This will, however, require that lending rates under these programs be progressively raised. Analysis by bank staff suggests that for the major schemes - KIK/KMKP, tree crops, export credits and housing - onlending rates to individual borrowers could be increased further, without significantly eroding the goals of the programs. For the KIK/KMKP and housing programs, there is a strong case for raising the onlending rate from the current level of 12%, which is below even the rate paid on the TABANAS small savings scheme (15%). In tree crops programs, onlending rates have been increased from 10.5% to 12%. However, consideration should be given to a further increase in the onlending rate to 15%. In instances where credit subsidies may be justified, it would be desirable to gradually transfer the financing of such subsidies from BI liquidity credits to a system of providing credit subsidies through the budget. Such a transfer will make the subsidies more transparent and could generate pressures to reduce subsidies. The shift need not necessarily involve an additional charge on the government budget, since the cost of a direct budgetary credit subsidy could be financed from the payment of interest by BI on government deposits held with Bank Indonesia.

(ix) World Bank staff projections (discussed earlier) also indicate that, if government deposits with Bank Indonesia were to increase more rapidly, or if the rate of implementation of the priority programs were to be slower than projected, there could be a need on occasion for Bank Indonesia to inject additional liquidity into the banking system. Bank Indonesia has

several instruments at its disposal for regulating domestic liquidity. However, its past reliance on credit ceilings has meant that it has not used the classic central bank instruments of changing reserve requirements or the discount window very actively. This limits the flexibility of Bank Indonesia in regulating monetary conditions, and it is important that these instruments be used more actively in the future. Bank Indonesia has recently introduced a new scheme - Money Market Securities (MMS) - in order to inject liquidity into the banking system by purchasing promissory notes from banks and non-bank financial institutions. In addition, Bank Indonesia might wish to consider purchasing CDs of appropriate maturities at market rates from the banks in order to recycle government deposits, in the event the growth of such deposits were to exceed presently anticipated levels. Such CD issues, provided they are consistent with the needs of monetary base management, could also help improve the maturity structure of the DMBs' deposits, and encourage the banks to increase their term lending.

(x) Another credit policy issue relates to bank financing of public enterprises. It is the Government's intention that public enterprises should acquire borrowed funds for investment and working capital at market terms. The recent increases in interest rates mean, however, that public enterprises will now have to pay at least 18% p.a. on their borrowing, as compared to about 13% p.a. earlier. Given the apparently weak financial position of a number of public enterprises, the authorities need to monitor the growth of public enterprise borrowing from the banking system very carefully. As a matter of general policy, the Government and banks should ensure that only enterprises with projects which can be funded on commercial terms, borrow from the banking system. The Government should also ensure that public enterprise borrowing does not crowd out the private sector from having adequate access to bank credit.

#### D. Cost and Availability of Credit

(xi) With regard to the cost and availability of credit, two important problems have emerged over the past two years: the high real cost of credit and the apparent hesitancy of state banks to provide long-term credit. Real lending rates of state banks now range from 9-15% p.a. and of private banks from 15-19% p.a. Moreover, the growth of long-term loans provided by state banks (which usually account for about three-quarters of term lending in Indonesia, with another one-fifth originating from the development banks), has slowed down since the June 1983 reforms.

(xii) The deceleration of state banks' term lending has been principally due to demand-related factors: the slowdown in the expansion of government expenditures affecting overall investment, the existence of unused domestic production capacity in a number of sectors, and uncertainties associated with domestic developments (tax reforms, etc.). High real interest rates themselves have affected profitability and the willingness to invest. In addition, on the supply side it appears that the state banks have become more cautious with regard to investment/term lending, as their costs of funds and lending risks have increased sharply (they are now expected to fund

longer-term loans outside the "priority" categories from their own resources) and the maturity structure of their deposit liabilities has shortened. In addition, informal controls have kept down state banks' nominal lending rates for term loans (state banks are expected to lend at around 18% p.a.) so that these rates are not sufficient to cover their increased costs and risks of term lending.

(xiii) The prospects for a reduction in real lending rates in Indonesia, as noted, depend on several important factors: the level of interest rates abroad; the extent to which the Government can influence expectations regarding future exchange rate movements between the Rupiah and the US dollar through appropriate domestic fiscal and monetary policies; oil price movements; and intermediation costs of Indonesian banks. Given the uncertainties with regard to oil price movements, it is difficult to predict the extent to which domestic interest rates in Indonesia will decline over the medium term, even with prudent monetary and fiscal policies. Although interest rates abroad have declined and the domestic inflation rate in Indonesia has abated significantly over the past year, domestic interest rates still remain high primarily because of uncertainties with regard to oil prices. On the other hand, reductions in intermediation costs are an important means available to the Indonesian authorities to help bring down domestic lending rates over the medium term; and it is therefore important that appropriate actions are taken in this regard. However, if this does not happen and real interest rates continue to remain high, investment demand could be adversely affected.

(xiv) Intermediation costs of state banks presently average about 7-8 percentage points of the interest rates charged. They mainly reflect high administrative overheads and large write-offs. The high overhead costs are due to weaknesses in the organizational structure of banks: inadequate organizational, management and control procedures and overmanning. The large write-offs reflect deficiencies in credit initiation and approval procedures, as well as inadequate loan supervision and recovery efforts.

(xv) There is considerable scope for reducing these high intermediation costs through improvements in the organizational structure and operating procedures of the state banks. In general, restructuring organization, improving management controls, reducing personnel, increasing automation and improving credit initiation and collection procedures could have a significant impact on banks' intermediation costs. In addition, present credit insurance arrangements should be reviewed with a view to inducing the banks to improve their loan collection efforts (by reducing insurance coverage provided by ASKRINDO and adjusting the premia paid by banks to reflect the nature of risks covered). The state banks are keenly aware of these needs. They have begun to take steps to improve their operational efficiency in many of these areas. Bank Indonesia has also over time made continued efforts to strengthen and improve the operational capabilities of the state and private banks. Notwithstanding the progress that has been made, more needs to be done. Banks also need to be more market oriented in order to attract lower-cost and more stable deposits to reduce their cost of funds (see below).

(xvi) In addition, in order to encourage term lending by banks, other actions could be taken particularly with regard to term-lending rates and the deposit mix of banks.

(xvii) In order to induce banks to increase term lending, long term lending rates of state banks will need to rise to reflect the banks' present costs and risks of lending. This would initially raise costs to borrowers. But, if banks lend at variable rates, as interest rates decline, the average cost to borrowers could be reduced over time as compared to the cost under present fixed long term rates. In addition, by capping interest payments, and if necessary, by extending the maturity of loans, it is possible to protect borrowers and match their debt-service payments with the cash flow of projects. To facilitate variable rate lending, it would be useful if either (a) banks announce their prime rate (as in the U.S.), or (b) Bank Indonesia calculates and publishes a system-wide average cost of term deposits weekly, as is done in the Philippines (Manila Reference Rate) and in Mexico (Average Cost of Loanable Funds). This would enable individual banks to quote loan rates which would vary over the life of the loan according to variations in the index, plus some fixed margin, while providing more information for the borrower than at present.

(xviii) Several steps could be taken to improve the deposit mix of banks. State banks could expand their base of low cost demand deposits by improving banking facilities in urban residential and rural areas, by increasing the range of financial instruments available (for example by introducing savings accounts with increased withdrawal facilities), and by promoting longer-term CDs; the latter, however, will require greater differentiation of interest rates than is presently paid on 12 and 24 month deposits. The banks' deposit mix could also be improved if Bank Indonesia were to place, within limits that are consistent with monetary base management, surplus government funds deposited with it as long-term CDs with commercial banks, at fixed or variable rates, as noted earlier.

(xix) At present, bank reserves held with BI earn no interest; this adds about 1-1.5% p.a. to the effective cost of funds of banks. The banks' costs of funds could be reduced somewhat if Bank Indonesia were to pay interest to banks (for example, close to the average costs of deposits of banks), on these reserves.

#### E. Strengthening the Development Banks

(xx) The second important source of term finance in Indonesia is the development banks. In the light of recent developments in the financial sector, the operational role of these institutions needs to be reassessed. The important issues in this regard are: (a) whether development banks should continue to be specialized institutions requiring government support, or whether they should be encouraged to be general purpose banks? and (b) if there is still a need for specialized development banks, how can they be made more viable and effective institutions?

(xxi) The development banks have an important role to play in Indonesia at least over the present decade. Given the difficulties faced by of commercial banks in providing term finance, development banks should be retained as an additional source of term financing. They could also play an important developmental role through the appraisal and supervision of projects and technical assistance to smaller and new entrepreneurs.

(xxii) It is also desirable to retain the specialized nature of development banks. If these banks are converted into general purpose banks, they are likely to go into short-term lending, of which there is already an adequate supply in Indonesia. Secondly, it is doubtful whether they can find and attract the requisite staff to organize, manage and operate commercial banking businesses, given the shortage of skilled manpower in the country. It would therefore be advisable that they focus instead on their present institutional and portfolio problems (see below) and strengthen their basic functions (project appraisal, technical assistance, etc.).

(xxiii) In order to make development banks more effective, a number of structural changes are needed to build up their institutional capabilities, make them financially viable and improve their long-term prospects. High priority should be given to efforts to improve the portfolio quality of development banks. Several actions can be taken in this regard. First, special task forces should be set up to review and draw up action plans to deal with problem loans. Such plans should write-off bad loans, reschedule those which are likely to become delinquent, and make adequate provision for possible losses. Special loan recovery units should also be set up to improve loan recoveries. Second, appraisal quality should be improved, by emphasizing consolidation, instead of expansion, of operations. For example, BAPINDO should strengthen credit departments at its head office and improve quality control and screening mechanisms for appraisal rather than expanding its branch network and scale of operations. Third, there is need to improve the quality and size of staff through hiring additional staff and staff training, particularly in loan appraisal and supervision work. Larger operational budget and better compensation packages for staff would be needed. For the longer term, facilities for training in the field of development banking should also be expanded. Fourth, sub-sector restructuring programs with Government assistance should be started to assist projects which have become delinquent due to changes in Government policies concerning sub-sectors; BAPINDO should work closely with its clients to implement appropriate financial/physical restructuring programs in this context. Finally, the legal system for recovery of loans and foreclosures should be streamlined.

(xxiv) To encourage the development banks to reduce their reliance on government funding over time a three-pronged approach could be adopted: (a) long-term lending rates should be allowed to find their market equilibrium. This would enable the development banks to match their lending rates with their risks and collateral and differentiate between borrowers according to such risks; (b) infusion of adequate equity by the Government in order to build up the capital base of development banks to enable them to keep down

their average costs of blended funds and to borrow from the market; (c) encourage development banks to raise funds directly from the market through time deposits and CDs at competitive rates, direct placements with pension funds and insurance companies at market rates and bond issues in the capital market.

(xxv) A combination of portfolio improvement, capital restructuring and raising funds from the market, with flexibility to adjust lending rates for more risky loans, should enable development banks to cover their normal operations. The additional costs involved in providing technical assistance and promotional work to smaller borrowers should be financed by the Government.

(xxvi) In order to increase the availability of venture capital, P.T. BAHANA should be substantially strengthened in terms of resources, staffing and technical capability to evaluate, assist and help manage smaller enterprises. In view of the paucity of technical staff and skills constraining development banks, an alternative approach would be to provide additional resources and to encourage the larger development banks (BAPINDO, PDFCI and UPINDO) to expand venture capital operations.

(xxvii) Regional Development Banks (RDBs). RDBs are generally very small units which primarily function as commercial banks to provincial governments, and do little development lending. Their capacity even for commercial banking operations, is limited. The emphasis over the next few years should be on improving their capacity for providing banking services efficiently and mobilizing resources, and undertaking development banking functions to assist small borrowers at the local level. For this purpose, several steps could be taken. First, association of smaller RDBs with nationwide commercial banks, with the latter entering into management contracts with each Regional Government, should be considered. Second, to improve staff quality and training, additional inter-regional training facilities should be set up. Third, to facilitate the ongoing development banking activities of RDBs, a technical assistance service facility for project appraisal should be established. Such facilities could be provided, for a fee, by the national development banks as well as by the national commercial banks who have such capacity. Fourth, RDBs should continue to receive government financial support. But, they should also be subject to similar pressures to mobilize resources as nationwide development banks.

#### F. Development of the Capital Market

(xxviii) At present, the capital market is a relatively minor source of long term finance. But, given appropriate policies, it can become an important source of investment finance over the longer term. Actions in the following areas would help revive the capital market.

(xxix) The removal of discriminatory tax treatment is essential to revive the capital market. (At present, interest income from bank deposits with maturities up to two years are tax-exempt, while income from capital market instruments are not. As a result, gross yields on bonds need to be around

28-30% p.a. in order to provide a net yield comparable to 18-20% obtainable on time deposits to investors). This could be done in one of two ways: either by removing the tax exemption of time deposits, or by extending the same concession to bonds. The case for retaining the tax exemption of time deposits is not convincing on equity grounds, since the benefits have accrued mainly to high income savers. A more compelling reason, however, is the fear of capital flight, unless deposit rates rise to compensate for the elimination of tax exemption. It is therefore suggested that income from bonds be also exempted from income and withholding taxes on a temporary basis. Such an exemption is unlikely to lead to significant revenue losses, while the potential gains from capital market development are likely to be considerable. The exemption could be withdrawn later on depending on the growth and maturity of the capital markets.

(xxx) Reform of the prevailing regulatory framework would also help to increase capital market activity levels. Such reform would help to: (a) increase the scope for market determination of prices for new public issues and make the capital market attractive to issuers, and (b) expand opportunities for capital gains in order to increase the attractiveness of capital market instruments to investors.

(xxxi) The roles of BAPEPAM, the regulatory agency in the Jakarta Stock Exchange, and of DANAREKSA (the national investment trust) in setting prices, determining the timing of new issues, and setting underwriting and sales commissions have had an unfavorable impact on market development. BAPEPAM, to encourage demand in a nascent market, has generally set prices of new issues too low. This has discouraged potential issuers from turning to the market. DANAREKSA has also stabilized share prices within narrow limits, thereby limiting opportunities for capital gains and eliminating a powerful incentive to investors. The dominant role of these institutions, especially DANAREKSA's preemptive right to buy 50% of new issues, has further hampered the development of underwriting.

(xxxii) In order to make the capital market attractive to potential borrowers and investors (a) BAPEPAM should gradually withdraw from active involvement in the pricing and timing of placement of issues and the determination of underwriting and sales commissions. (b) DANAREKSA's preemptive right to acquire 50% of any new issue should be phased out. This would still leave DANAREKSA free to operate as an underwriter; but it would provide an equal opportunity for all underwriters (including, but not predominantly, DANAREKSA) to purchase new issues.

(xxxiii) In addition to the removal of fiscal disincentives, the bond market could be further encouraged by relaxing somewhat the eligibility criteria for companies for listing in the stock exchange. For example, the present eligibility criteria, by limiting bond issues to 100% of net worth, prevent financial companies from issuing bonds. By relaxing the debt-equity ratio requirement, supplemented by an additional debt service coverage requirement (so that net income before debt service and taxes would be an appropriate multiple of debt service) financial companies can be enabled to issue bonds, while protecting the investors' interests. Secondly, some public enterprises,

particularly those of a commercial nature, or those who can earmark part of their revenues for retirement of bonds, (such as toll roads, the telephone company, and other utilities) could be encouraged to issue bonds. However, government guarantees may be needed for this purpose.

(xxxiv) Finally, a number of other actions of a longer term nature are needed to encourage capital market development. These include: (a) promotion of insurance schemes and pension funds in the corporate sector and individual financial security plans to encourage savings and increase the demand for financial instruments; (b) introduction of new institutions such as investment trusts/mutual funds and venture capital companies to fill gaps in the capital markets; (c) introduction of new financial instruments such as floating rate obligations to address market uncertainties; (d) expansion of the scope of audited financial statements, and adequate and timely disclosure and reporting requirements for both public and private companies; (e) broadening of the criteria for listing issues on the stock exchange through the introduction of a second category; (f) greater leeway to institutional investors to make private placements; and (h) comprehensive training and technical assistance.

## Chapter 1

### MACROECONOMIC DEVELOPMENTS AND THE DEVELOPMENT OF THE FINANCIAL SECTOR IN INDONESIA, 1978-84

#### A. The Indonesian Financial System

1.1. Over the past 7 years the Indonesian financial system has grown rapidly in terms of size, strength and the complexity of its institutions. As in most countries, the system is dominated by the banks. Bank Indonesia (BI), the nation's central bank, accounts for almost 42% of the gross assets of the financial system (Table 1.1). The deposit money banks (DMBs) account for the bulk of the remaining assets; in December 1984, Indonesia's 113 DMBs had total assets of Rp. 27.8 trillion, equivalent to 54% of gross financial assets. The DMBs vary greatly in size and strength. The five state commercial banks are the largest DMB's, both in terms of assets (estimated at 69% of DMB assets) and number of branches. They also account for the bulk of bank credit (66% in December 1984) and especially long term lending (79% in December 1984). The private banks, which have been recently growing rapidly in terms of their share of assets and credit, mostly concentrate on lending for working capital purposes. In contrast to the state banks, they rely more heavily on deposits mobilized from the public to fund their activities. Thus while they account for only 15% of total assets of the DMB's, they account for 60% of the rupiah deposits of private enterprises and individuals. Included in the DMBs are 28 development banks comprising a state development bank (BAPINDO) - which is by far the largest in this group - and 27 regional development banks. In addition, there are two small joint-venture development banks (PDFCI and UPPINDO) and a venture capital company (BAHANA); together, these development finance institutions account for 4.4 percent of gross assets of the financial system.

1.2 Non-bank financial institutions (NBFIs) have also come to play an increasingly important role in the economy. The assets of these institutions currently total over Rp. 1.3 trillion, equivalent to approximately 2.6% of the assets of the financial system. This group also includes Bank Tabungan Negara (BTN) - the state savings bank - which is an important source of institutional finance for the housing sector. Together with leasing and insurance companies the NBFIs are becoming a significant financial force and a potentially important alternative to conventional bank financing. The Government has also fostered the development of equity and bond markets, although these are relatively small at present. The first share issue of the stock exchange took place in 1977; since then there have been 23 more issues bringing the value of issues by December 1984 to Rp. 131 billion at issue prices. The bond market is even more recent. The first bond sales took place in 1983 in the form of five year bearer bonds issued on behalf of three public enterprises totalling Rp. 95 billion, followed by further issues totalling Rp. 130 billion by one of the three enterprises in 1984.

Table 1.1: GROSS ASSETS OF THE INDONESIAN FINANCIAL SYSTEM, DECEMBER 1984

	No.	Assets Rp. billion	Share of Assets (in %)	Growth of Assets 1977-1984 (% p.a.)
Bank Indonesia	1	21,618	41.8	29.4
Deposit money banks	113	27,768	53.6	31.6
State commercial banks	(5)	(19,241)	(37.3)	(n.a.)
Private foreign exchange banks	(10)	(2,393)	(4.6)	(n.a.)
Foreign banks	(11)	(2,192)	(4.2)	(31.7)
Other commercial banks	(59)	(1,666)	(3.1)	(35.6)
Development banks	(28)	(2,276)	(4.4)	(34.5)
Rural and savings banks	5,826	18 <u>/a</u>	..	n.a.
Non-Bank financial institutions	14	1,327	2.6	39.8
Insurance companies <u>/b</u>	89	597	1.2	n.a.
Leasing companies	38	386	0.7	n.a.
State pawnshops	474	59 <u>/a</u>	0.1	20.5
<u>Total</u>	<u>6,556</u>	<u>51,773</u>	<u>100.0</u>	<u>29.1</u>

/a Loans outstanding as of September 1984.

/b December 1982.

n.a.: not available.

Source: Bank Indonesia.

1.3 The Potential for Financial Deepening. Table 1.2 presents some comparisons between the banking sector in Indonesia and those of some other countries in the East Asia region. Firstly, despite a sharp increase in time and savings deposits since the June 1983 reform (para 1.26 below), the share of time and savings deposits in total deposits in Indonesia is still low - only 66% compared to a range of 81% (Malaysia) and 94% (Thailand) in other countries. Even this understates the extent of the difference between Indonesia and these other countries. In the case of the Philippines, Malaysia and Thailand the figures refer only to the commercial banks; however, all of these countries have important savings and loan institutions or government savings banks which accept time deposits. If these savings were taken into account the differences between Indonesia and these countries would be correspondingly greater.

Table 1.2: SELECTED FINANCIAL INDICATORS - SOME INTERNATIONAL COMPARISONS /a

	Share of Time and Savings in Total Deposits - %	Money % GDP	Money plus Quasi Money % GDP
Indonesia /b	65.7	9.6	19.5
Philippines /c	85.1	5.7	18.2
Malaysia /c	80.9	19.0 /d	58.5 /d
Thailand /c	93.8	8.9	50.6
Korea /b	81.3	9.8	35.2

/a Based on 1984 data.

/b Deposit Money Banks.

/c Commercial banks.

/d 1983.

Source: IFS and World Bank staff estimates.

1.4. Secondly, in comparison with other East Asian countries, Indonesia's banking system is still relatively small in relation to its GDP. The proportion of money relative to GDP in Indonesia is in the middle of the range of these countries. However, the proportion of money plus quasi money to GDP is considerably lower than in the other countries, with the exception of Philippines. This is because of the much lower share of time and savings deposits in total bank assets. As a result of this low level of savings and time deposits the financial sector in Indonesia is not very "deep". There is, therefore, considerable scope for increasing financial savings and improving financial intermediation.

#### B. Macroeconomic Developments and the Growth of the Banking System

1.5 Macroeconomic Developments Since 1978. Table 1.3 illustrates some of the key macroeconomic developments which have influenced the performance of the banking system since 1978. Between 1978 and 1981 the economy, buoyed by rising oil prices, experienced a period of rapid economic growth averaging almost 8% per year. However, strong inflationary pressures surfaced between 1978 and 1980. These were partly induced by the rise in Indonesia's export prices -- both oil and non-oil commodity prices improved dramatically -- and the pass-through effects of the November 1978 devaluation. These pressures were further reinforced by rapid increases in public expenditures and expansionary credit policies. However, as the oil market began to soften in 1982, Indonesia's GDP growth rate declined to an average of about 3% during 1982-1983. The inflation rate also declined markedly in the early eighties, as public expenditure and credit growth began to slow down from their previous record rates.

1.6 The data on aggregate investment in Indonesia have to be interpreted cautiously, but they suggest that investment expenditures rose steadily in real terms until about 1982. The national accounts data indicate that the share of investment in GDP in real terms climbed from 20.5% of GDP in 1979 to about 25.9% in 1982. The growth of investment was a major factor fueling the overall growth of GDP until 1982. After an initial decline (in relation to GDP) in 1979 public sector investment rose sharply. The combination of a buoyant domestic home market, relatively easy credit conditions and government policies favoring increasing domestic industrial capacity also gave a powerful stimulus to private investment in the 1978-82 period. Since then, public investment and private investment, particularly in industry and commerce, appear to have slowed substantially.

Table 1.3: MACROECONOMIC INDICATORS, 1978-83

Calendar Year	1978	1979	1980	1981	1982	1983
International oil price (\$bbl current prices)	12.9	18.6	30.5	34.3	33.2	28.4
GDP growth rate /a	7.7	6.3	9.9	7.9	2.2	4.3
Consumer price index (% annual change)	6.7	24.0	17.1	7.3	10.0	12.0
As % of GDP						
Total investment	20.5	20.9	20.9	23.4	25.9	21.2
Public investment	10.2	6.6	9.0	11.8	13.8	10.1
<u>Fiscal Year /b</u>	<u>1978/79</u>	<u>1979/80</u>	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>
Growth of public expenditures (Constant 1973 prices)	11.7	15.0	12.3	24.7	8.3	-11.4
As % GDP						
Central Government surplus/ deficit (-)	n.a.	1.3	1.0	-2.6	-5.7	-1.7
Current account surplus/ deficit (-)	-3.3	4.6	3.2	-3.2	-7.9	-5.6

/a At constant 1973 prices.

/b The Indonesian Fiscal Year runs from April 1 to March 30.

n.a: not available.

1.7 The rise in oil prices, coupled with production increases and the devaluation in November 1978, gave a substantial boost to budget revenues. Between 1978/79 and 1981/82 oil revenues almost quadrupled in Rupiah terms, while their share in total government revenues increased from 54% to 71%. This has meant that the Government's budgetary position has become more dependent on oil revenues and more sensitive to changes in the exchange rate of the Rupiah. Thus as Indonesia's oil exports declined in 1982/83 oil taxation receipts fell by 4%; but in 1983/84 the budgetary impact of the decline in international oil prices was more than offset by the impact of the

devaluation of the Rupiah, so that budgetary revenues from oil climbed by 25% to a new high of Rp. 10.4 trillion, equivalent to 14.1% of GDP.

1.8 Analysis of available data suggests that the financial position of the Government has shifted from surplus to deficit over the last five years, even though the budget has officially been in balance.<sup>/1</sup> In the period 1979/80 - 1980/81 the Government budget was in surplus, equivalent to about 1% of GDP, even though expenditures climbed rapidly (Table 1.3). However, during 1981/82 and 1982/83 the budgetary position of the Central Government deteriorated in line with declining oil receipts, so that by the latter year the budget deficit exceeded 5% of GDP. On a net basis the government deposits with the banking system fluctuated equally sharply. In 1979/80 and 1980/81 these deposits rose by 3.8% and 4.1% of GDP respectively. However, in 1981/82 government deposits with the banking system barely increased; and in 1982/83 they actually declined.

1.9 Faltering oil revenues largely accounted for an equally dramatic reversal in Indonesia's balance of payments position, from a surplus equivalent to 4.6% of GDP in 1979/80 to a deficit of 7.9% of GDP in 1982/83. Confronted with this balance of payments deficit and the prospect of continuing weakness in the international oil market, the Government introduced a series of reforms aimed at restoring macroeconomic balance. The rupiah was devalued by 28% on March 30, 1983 giving a substantial boost to government rupiah revenues, as well as the profitability of non-oil exports. Government expenditures were tightly constrained in 1983/84; oil subsidies were sharply reduced; and a major review of the public investment program was completed resulting in the rephasing, postponement or cancellation of some 45 projects thereby effecting a foreign exchange saving of \$10 billion. These measures have had a quickacting effect on both the balance of payments and the Government's financial position. More importantly they have reinforced the momentum for longer term adjustments, as well as creating a favorable environment for the financial sector reform introduced in June 1983.<sup>/2</sup>

1.10 Financial Sector Developments, 1978-83. The Government's comfortable financial position since 1978, its policy of channeling surplus government funds through the banking sector and rapid economic growth provided the basis for a rapid expansion of the banking system. During the period 1978-83, the total assets of the deposit money banks (DMBs) - the dominant financial

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<sup>/1</sup> As presented in the official accounts the Central Government's budget is always shown as balanced. This partly reflects the Indonesian convention of showing foreign (project and program) financing as a revenue item and amortization as an expenditure item rather than the conventional practice of showing these transactions as below the line financing items. In addition, budgetary expenditures and revenues are not fully recorded on a cash basis. Finally there are off-budget expenditures (most notably lending by the Central Government to public enterprises). Once these factors are taken into account the Government may have an actual deficit or surplus in any given year. This has important implications for the conduct of monetary policy which are discussed in Chapter 2.

<sup>/2</sup> See World Bank Report No. 5066-IND, "Indonesia: Policies and Prospects for Economic Growth and Transformation", April 26, 1984.

institutions in Indonesia - virtually quadrupled. Although domestic inflation accounted for much of this increase, there was still substantial real growth averaging almost 11% p.a.

1.11 As Table 1.4 shows, total deposits of the banking system also increased sharply from Rp. 4.1 trillion at the end of 1978 to Rp. 14.4 trillion in June 1983, representing an average real rate of increase of 11% p.a., considerably faster than the growth of GDP (6.8%). A major source of this deposit growth was public sector deposits. Most of this growth occurred between 1978 and 1981 when public sector deposits climbed from 42% to 58% of total deposits. A major component of this increase was the current account deposits of the Central Government with Bank Indonesia. But deposits of central and local Governments as well as public enterprises with the DMBs also increased substantially. Since 1981 private sector savings with the DMBs have grown significantly in importance as a source of funds for the banking system, rising from 42% to 52% of total deposits.

Table 1.4: GROWTH OF DEPOSITS WITH THE BANKING SYSTEM, DECEMBER 1978-JUNE 1983  
(Rp. billion)

	1978	1979	1980	1981	1982	1983	Av. real growth 1978-83 /a
	Dec.	Dec.	Dec.	Dec.	Dec.	June	(%)
<u>Bank Indonesia</u>							
Central Govt. deposits	920	1,643	3,125	3,903	3,931	3,678	12.9
Other non-bank deposits	260	317	365	421	352	562	-0.2
<u>Deposit Money Banks</u>							
Demand deposits	1,193	1,737	2,795	3,847	4,134	4,148	9.9
Time deposits	1,054	1,140	1,481	2,033	2,491	3,344	12.8
Foreign exchange deposits	263	670	1,174	1,094	1,406	2,044	16.5 /b
Central Govt. deposits	444	373	735	914	691	652	-6.5
<u>Total banking system</u>	<u>4,134</u>	<u>5,880</u>	<u>9,675</u>	<u>12,212</u>	<u>13,005</u>	<u>14,428</u>	<u>11.4</u>
<u>Memo items:</u>							
Public sector deposits as % of total banking system deposits /c	41.6	50.5	56.3	57.8	52.1	47.8	13.4
Currency in circulation (Rp. billion)	1,240	1,552	2,153	2,557	2,934	3,284	4.5

/a Using the GDP deflator at 1973 prices.

/b 1979-1983.

/c Public sector comprises central and local Government, official entities and public enterprises.

Source: Bank Indonesia.

1.12 As a result of the growth of its deposits with Bank Indonesia the Central Government has become an increasingly important net creditor to the banking system (Table 1.5). With the exception of 1982 when the Government reduced its net deposits to help finance its budget deficit, net credits from the Government have risen substantially each year. At the same time, public enterprises have been able to meet their credit needs largely through foreign borrowing and direct equity contributions from the Government. They have, accordingly, reduced their real borrowing from the domestic banking system. Between 1978 and 1983 credits to public enterprises from the banking system declined by 6% p.a. in real terms. Consequently, the net demand of the public sector as a whole (Central Government plus public enterprises) on the banking system has fallen sharply (line 5, Table 1.5). In 1978, the public sector accounted for 43% of credit from the banking system. By June 1983 public sector share had fallen to about 10%, since public enterprise borrowing was largely counterbalanced by Central Government deposits with the banking system.<sup>/1</sup> This reduction in public sector borrowing facilitated a rapid increase in lending to the private sector between 1978 and 1983. In nominal terms, the level of outstanding credit to the private sector increased from Rp. 2.6 trillion in December 1978 to Rp. 9.3 trillion in June 1983. In real terms credit to the private sector rose at an annual average rate of 12%.

Table 1.5: CREDITS FROM THE BANKING SYSTEM, DECEMBER 1978-JUNE 1983  
(Rp. billion)

	1978 Dec.	1979 Dec.	1980 Dec.	1981 Dec.	1982 Dec.	1983 June	Average Real Growth 1978-83/ <sup>a</sup> (%)
Public enterprises	2,796	3,167	3,655	4,247	4,979	5,020	-3.1
Private sector	2,604	3,159	4,339	6,095	8,312	9,284	12.4
Total domestic credit	<u>5,400</u>	<u>6,326</u>	<u>7,994</u>	<u>10,342</u>	<u>13,291</u>	<u>14,304</u>	<u>5.4</u>
<u>Memo items:</u>							
Net deposits of Central Government	-878	-1,703	-3,619	-4,179	-3,757	-3,678	15.9
Public sector net credit <sup>/b</sup>	(1,918)	(1,464)	(36)	(68)	(1,222)	(1,342)	-
Public sector credit (net) as % of total bank credit	35.6	23.1	0.5	0.7	9.2	9.4	-
Total bank credit as % of GDP	23.7	19.8	17.6	19.1	22.3	22.0	-

<sup>/a</sup> Using the GDP deflator at 1973 prices.

<sup>/b</sup> Excluding deposits of public enterprises.

Source: Bank Indonesia and World Bank staff estimates.

<sup>/1</sup> If public enterprise deposits with the banks are also taken into account the public sector was a net creditor to the banking system during most of the 1979-1983 period.

1.13. Credit and Interest Rate Policies Prior to June 1983. The most important instrument of credit policy in Indonesia is the liquidity credit system, which has been used as a means of channeling surplus government funds into the economy while providing additional credit to priority borrowers. The liquidity credit system has two components. First, Bank Indonesia provides direct credits to certain borrowers, notably public enterprises and other governmental organizations. Since 1978, these credits have been growing relatively slowly and their share in Bank Indonesia credits has been declining steadily (Table 1.6). The second and increasingly more important category of liquidity credit is Bank Indonesia's credit to the banking system. For designated activities the state banks are allowed to rediscount a proportion of their investment and working capital credits at preferential interest rates (para 2.26).<sup>/1</sup> During the period December 1978-June 1983, Bank Indonesia's credits to the banking system increased at a nominal rate of 41% annually; and as a result DMBs accounted for 64% of total liquidity credits <sup>/2</sup> as of end-June 1983.

Table 1.6: SHARE OF BANK INDONESIA IN TOTAL DOMESTIC CREDIT,  
DECEMBER 1978-JUNE 1983  
(Rp. billion)

	1978 Dec.	1979 Dec.	1980 Dec.	1981 Dec.	1982 Dec.	1983 June
B.I. direct credits	1,958	2,188	2,483	2,692	2,853	2,349
B.I. credit to the banking system	846	1,129	1,722	2,547	3,742	4,253
Bank credits from own resources	2,596	3,009	3,789	5,103	6,696	7,702
Total domestic credit <sup>/a</sup>	<u>5,400</u>	<u>6,326</u>	<u>7,994</u>	<u>10,342</u>	<u>13,291</u>	<u>14,304</u>
<u>Memo Items:</u>						
B.I. share in total credit (%)	51.9	52.4	52.6	50.7	49.6	46.2
B.I. credits to banks as % of bank lending	24.5	27.3	31.2	33.2	35.8	35.6

<sup>/a</sup> Excluding credit to Central Government.

Source: Bank Indonesia.

<sup>/1</sup> Private banks are also allowed to rediscount credit for certain working capital purposes; but they have made only limited use of these facilities, so that they account for only 5% of the currently outstanding liquidity credits.

<sup>/2</sup> In addition Bank Indonesia stands ready to make liquidity credits available to banks experiencing liquidity problems through 3 discount windows.

1.14. Consequently, Bank Indonesia accounted for a high proportion of domestic credit; between 1978 and 1982 Bank Indonesia's share exceeded 50%. With the growth of its credits to the banking system, Bank Indonesia has become an important source of funds to the DMBs. In 1978 Bank Indonesia's credits to the banking system were equivalent to almost 25% of the value of DMBs' lending; by June 1983 this proportion had risen to 36%.

1.15. Bank Indonesia's indirect credits have underpinned a substantial volume of lending to the private sector (Table 1.7). Bank Indonesia credits accounted for about 30% of total lending to the private sector in 1983; Bank Indonesia's share in investment credit extended to the private sector was even higher - 46% in 1983. Assuming that Bank Indonesia refinances on average 75% of the total value of loans that it discounts, Bank Indonesia-supported lending accounted for about 60% of total long-term DMB lending to the private sector in 1983. Thus Bank Indonesia has been a major contributor to the process of financial intermediation in Indonesia, particularly with respect to the provision of term financing for the private sector.

Table 1.7: LIQUIDITY CREDIT PROGRAMS IN RELATION TO BANK LENDING TO THE PRIVATE SECTOR, DECEMBER 1978 - MARCH 1983  
(Rp. billion)

	1978 Dec.	1979 Dec.	1980 Dec.	1981 Dec.	1982 Dec.	1983 Mar.	1983 March	
							Working Capital	Investment Credits
Bank lending to private sector	2,572	3,115	4,270	5,987	8,127	9,721	6,992	2,729
(Of which liquidity credits)	540	645	1,043	1,394	2,284	2,932	1,666	1,266
Share of liquidity credits (%)	21.0	20.7	24.4	23.3	28.1	30.1	23.8	46.4

Source: Bank Indonesia and World Bank staff estimates.

1.16. Prior to the deregulation measures introduced in June 1983, BI also set deposit rates paid by state banks, except for 3 month time deposits. However, private banks were not subject to interest rate regulations. The system generated a complex interest rate structure. As Table 1.8 shows, large discrepancies emerged between the returns available to depositors with state and private banks. On 12 month time deposits, the state banks paid a rate of 9% between December 1979 and March 1983, while the private banks paid between 19.3% and 20.1%. There were also wide differences on three month time deposits, even though the state banks were free to set these rates. However, since public enterprises and official government bodies are generally obliged to maintain their accounts with the state banks, the latter were able to pay lower rates without losing their deposits to the private banks.

Table 1.8: SELECTED AVERAGE INTEREST RATES, DECEMBER 1978-MARCH 1983 /a  
(% p.a.)

	1978 Dec.	1979 Dec.	1980 Dec.	1981 Dec.	1982 Dec.	1983 Mar.
<u>3 month time deposits</u>						
State banks	n.a.	5.1	8.2	10.2	8.6	9.6
Private banks	12.0	16.7	16.1	17.4	17.1	17.4
<u>12 month time deposits</u>						
State banks	9.0	9.0	9.0	9.0	9.0	9.0
Private banks	15.0	19.6	20.1	19.4	19.3	19.3
<u>24 month time deposits /b</u>						
State banks	15/12	15/12	15/12	15/12	15/12	15/12
Private banks	15.0	19.6	19.3	19.0	18.8	19.3

/a Mid-point of range.

/b 15% p.a. on amounts upto Rp. 2.5 million and 12% p.a. on amount over Rp. 2.5 million.

Source: Bank Indonesia.

1.17 Until June 1983 the liquidity credit system was also associated with credit ceilings. Credit ceilings were introduced initially in an effort to restrain aggregate credit. However, these ceilings gradually grew in complexity, so that each individual bank in the system was subject to both aggregate and an increasing number of sectoral lending limits.

1.18 Since the liquidity credits were provided at low interest rates (3-4% p.a.) BI also regulated the lending rates of state banks /1; nominal lending rates for priority loans were set at 12% p.a. or less, while the state banks charged around 13.5% on other loans. Thus, the average state bank lending rates were about 12.5 percent (compared with 26 percent charged by the private banks) and were slightly negative in relation to the consumer price index (-1 to -3%) and substantially negative in relation to the GDP deflator (-7 to -8%)./2 These credit and interest rate policies succeeded in directing a substantial volume of credit resources toward the priority sectors. However,

/1 Lending rates charged by the state banks on the credit programs financed by Bank Indonesia liquidity credits continue to be subject to Bank Indonesia regulation; but the number of programs eligible for liquidity credits has been reduced (para 1.20 below).

/2 Differences between the GDP deflator and consumer prices during this period were due to differences in the composition of the basket (relative price effects), government subsidies, price controls and taxation and international oil price movements.

they have had a retarding effect on private financial savings and the development of the financial system, since the state banks had little incentive to mobilize private savings. Similarly, since private banks were subject to credit ceilings, there was no incentive for them to attract more deposits than were needed to finance permissible lending operations. Limitations (since removed) on the ability of the private banks to open branches also appear to have handicapped them in attracting new deposits.

### C. The Financial Sector Reform

1.19 The June 1983 Measures. During the Seventies and early Eighties the possible negative impact of these policies on private financial savings was not an overriding concern, given the success of the banking system in meeting the credit needs of priority borrowers. The overall level of financial savings was considered to be sufficient to meet the needs of the economy for credit. However, as Indonesia's external position deteriorated in 1982, and its implications for government revenues and savings became clear, it was recognized that more attention was needed to encourage the mobilization of private financial savings in order to finance domestic investment. Accordingly, in June 1983, the Government introduced a major reform of the financial sector with a view to supporting its broader policy efforts of improving the country's balance of payments position and domestic finances. As regards the financial sector, the main objectives of the reform are to (a) reduce the dependence of the banking system on Bank Indonesia liquidity credits; (b) stimulate private financial savings and; (c) over the longer term to lay the foundation for the development of a more dynamic, efficient, and resilient banking system capable of meeting the growing needs of the economy for more sophisticated financial services.

1.20 There are 3 main elements to the reform. First, state banks are now free to set their deposit rates on all maturities, except for the Tabanas (small savings) scheme.<sup>/1</sup> Second, credit ceilings were eliminated for all banks. Third, the number of programs qualifying for new Bank Indonesia liquidity credits was substantially reduced. As of March 1983, 59% of Bank Indonesia's credits to the banking system have been categorized as non priority credits. In addition, Bank Indonesia's rediscount rate was unified at 3%, and with a few exceptions, the onlending rate for loans under the liquidity credit programs set at 12%.<sup>/2</sup> For other loans the state banks are now free to set interest rates. However, Bank Indonesia continues to consult with the state banks on lending rates. It appears that for long term loans they are expected to charge no more than 18%, while for working capital rates of 21-24% are currently charged.

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<sup>/1</sup> For TABANAS accounts depositors now receive a rate of 15% for deposits up to Rp. 1,000,000 compared to the previous limit of Rp. 200,000. For amounts above this ceiling the interest rate has been raised from 6% to 12%. The only other interest rate regulation in force is that state banks must pay a minimum interest rate of 12% on 12 month time deposits.

<sup>/2</sup> Bank Indonesia's rediscount rate for the KUPEDES (village credit) scheme is 15%, lending rates for export credits are determined by the individual banks, and the paddy field construction on-lending rate is 10.5%.

1.21 Deposit Interest Rates. These reforms have already had a dramatic effect on the banking system. A major effect has been a sharp rise in deposit rates paid by the state banks (coupled with much smaller increases in the deposit rates paid by private banks on certain accounts). The mid-rates paid on time deposits by state banks rose from a range of 6-12% to a range of 16-18% (see Table 1.9). As a result, the deposit rates of state banks are now much closer to those offered by the private banks; for most classes of deposits the premium paid by private banks over state banks is now only about 2% on an annual basis.

Table 1.9: CHANGES IN BANK INTEREST RATES, MARCH 1983 - DECEMBER 1984  
( in % per annum)

	March 1983	June 1983	Dec. 1983	June 1984	Dec. 1984
<u>Selected interest rates</u>					
<u>3 month deposits /a</u>					
State banks	9.6	16.5	15.7	15.7	17.0
Private banks	17.4	17.4	17.0	17.1	19.6
<u>12 month deposits /a</u>					
State banks	9.0	16.5	17.5	17.4	20.0
Private banks	19.3	19.5	19.7	19.5	21.5
<u>24 month deposits /a</u>					
State banks	15/12	16.5	17.1	17.1	20.5
Private banks	19.0	18.8	19.3	19.5	21.5

/a Mid-point of range offered on new deposits.

Source: Bank Indonesia and World Bank staff estimates.

1.22 In the year following the June 1983 reform the pattern of deposit rates changed very little; the monthly fluctuations in the average rates generally did not exceed 50-120 basis points. More recently increased uncertainties with regard to future oil price movements and a surge in interest rates in the interbank market in August/September, 1984 /1 appear to have put some upward pressure on deposit rates.

1.23 The deposit interest rate realignment since June 1983 has two analytically separate components. First, in order to become more competitive with the private national banks the state banks have raised their rates on individual and private enterprise deposits. Second, the deregulation of

/1 Interest rates in the interbank call money market have been more volatile than deposit rates, in part reflecting changes in underlying short-term macroeconomic conditions at home and abroad, and in part expectations over the conduct of monetary and exchange rate policy (para 2.5 below). This volatility was particularly apparent in the early part of 1984 and again between June and September of 1984.

interest rates has meant that the state banks have to compete against one another more aggressively. This has led to a rise in the rates paid to organizations which are obliged to maintain their deposits with the state banks to more or less the same level as that for private deposits. The private national banks on the other hand have not changed their deposit rates significantly, since they were already competing in an unregulated way for private deposits.

1.24 The interest rate deregulation has therefore affected the private and the state banks very differently. The private banks have not experienced a very significant change in their cost of funds. On the other hand, the cost of funds of the state banks has risen sharply. While the extent of this cost increase has varied among state banks, the average increase has been about 4 percentage points, so that their average borrowing costs are currently in the 7-9% range.<sup>/1</sup> The marginal cost of funds for the state banks has risen more sharply, averaging about 15% p.a. over the past year at prevailing deposit rates.<sup>/2</sup> This rise in borrowing costs is a matter of concern to the authorities, since the increased costs have to be passed on to borrowers in the form of higher lending rates.

1.25 Given this realignment of state bank deposit rates, all depositors now earn a substantial real return on their savings deposits. For example, in relation to the rate of consumer price inflation of the previous year, real interest rates on 3 month time deposits at state banks rose from 0% in March 1983 to 5% in March 1984.<sup>/3</sup> Real interest rates have continued to rise in 1984, as the underlying rate of inflation in 1984 has slowed compared with 1983. This in turn has raised real lending rates outside the special credit programs to high levels (para 3.8). Most of the increase in state bank lending since June 1983 has been made at nominal rates of 18-24% (a real interest rate of 9-15%) while the private banks have been charging nominal rates of between 24-28% (a real interest rate of 15-19%) for working capital loans.

1.26 Commercial Bank Deposits. The realignment of deposit interest rates since June 1983 has been accompanied by a rapid increase in bank deposits, particularly time deposits; in the June 1983 - June 1984 period total bank deposits increased by 29%; and time and savings deposits by 74%.<sup>/4</sup> As a result of this rapid growth in time deposits, the share of rupiah demand deposits in total deposits fell steadily, from 43% in June 1983 to 33% by June 1984.

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<sup>/1</sup> The average cost of state banks' funds is still relatively low because liquidity credits from Bank Indonesia still account for about 40% of state banks' loanable resources. However, since the availability of new liquidity credits has been sharply reduced, the incremental costs of state bank funds mobilized in the form of deposits are now much higher (Table 3.1).

<sup>/2</sup> This, in turn, partly reflects the rise in deposit rates since the deregulation and the rapid growth of time deposits, while demand deposits increased less rapidly (Table 1.10).

<sup>/3</sup> The consumer price index rose by 10% in 1982 and 12% in 1983.

<sup>/4</sup> This compares with increases of 14 and 27% respectively in the period March 1982-March 1983.

1.27. Both state and private banks have succeeded in increasing their deposits substantially since June 1983 (Table 1.10). In the case of private banks, both demand and time deposits recorded high growth rates; but there was still a definite shift in deposit composition toward time and savings deposits. In the case of state banks, the shift was particularly marked; the share of time and savings deposits in the total deposits of state banks increased from 32% to 47%.<sup>/1</sup> The other noteworthy development is the continuing growth in foreign exchange deposits.

Table 1.10: GROWTH OF DEPOSITS WITH THE BANKING SYSTEM,  
JUNE 1983-DECEMBER 1984  
(Rp. billion)

	June 1983	June 1984	December 1984	Nominal Growth	
				June 83 June 84	June 84- Dec. 84
				---- % p.a. ----	
<u>Private national banks</u>					
Rp. Demand deposits	749	907	879	21.1	-6.2
Rp. Time and savings deposits	839	1,528	1,830	82.1	39.5
Foreign currency deposits	136	215	333	58.1	109.8
<u>State banks</u>					
Demand deposits	2,857	2,544	3,080	-11.0	42.1
Time and savings deposits	1,979	3,625	3,763	83.2	7.6
Foreign currency deposits	1,328	1,527	1,872	15.0	45.2
<u>Total deposit money banks /a</u>					
Demand deposits	4,148	4,095	4,817	-1.3	35.3
Time and savings deposits	3,344	5,831	6,387	74.4	19.1
Foreign currency deposits	2,044	2,398	2,944	17.3	45.5

/a Difference between sum of private national banks and state banks and total deposit money banks is accounted for by foreign banks and local development banks.

Source: Bank Indonesia.

/1 For private banks, the share of time deposits increased from 49% to 58%.

1.28. Increases in interest rates paid by state banks and the overall pattern of interest rates were an important factor underpinning the growth of time and savings deposits. But the surge in these deposits cannot be adequately accounted for by interest rate developments alone. As already noted, the interest rate paid to private sector individuals and enterprises by private banks did not change significantly either in real or nominal terms. Clearly other influences have also been at work. Renewed confidence in the Rupiah following the March 1983 devaluation (reflected in some reflow of capital back to Indonesia); the limited impact of the devaluation on domestic prices; public awareness of the stabilisation measures, a strong foreign exchange reserve position, and the financial sector reform and; finally, favorable tax treatment on interest income /1 all undoubtedly played a part, although it is difficult to quantify their effects.

1.29 In the last six months of 1984, the growth of rupiah time and savings deposits slowed down to an annual rate of about 19%, while growth of foreign currency (dollar-denominated) deposits accelerated sharply to an annual rate of 46%. (Demand deposits which generally remained flat since the June 1983 reform also increased significantly towards the end of 1984; but this increase largely reflected a temporary accumulation of funds by public enterprises). Some slowdown in rupiah time deposits was to be expected as portfolio shifts are essentially completed. The pronounced shift from rupiah time deposits to dollar-denominated deposits was, however, probably due to expectations of continued depreciation of the Rupiah against the US Dollar, given the softening of oil prices and the strengthening of the Dollar abroad./2

1.30 Individuals and private enterprises together accounted for slightly more than half (57%) of the growth of time deposits during the period from March 1983 to February 1985 (Table 1.11). The public sector also made a significant contribution to time deposit growth; Government and state enterprises accounted for nearly one-fifth of the overall increase in time deposits during the same period. Deposits of state enterprises grew particularly rapidly, perhaps indicating a response to the higher level interest rates paid to them since deregulation. The sharp rise in the deposits of insurance companies is also noteworthy. The growth of these deposits may also reflect a shift in the portfolio preferences of these groups toward financial savings. However, it is not clear whether this may be a result of interest rate deregulation, or the new income tax concessions noted above.

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/1 Interest income from time deposits with maturities of two years or less are exempt from income taxes for an unspecified "temporary" period (para 5.11 below).

/2 Preliminary data for April 1985 indicate some recovery in the rate of growth of rupiah time deposits in the first four months of 1985 to an annual rate of about 34%, while the growth of demand deposits slowed down to an annual rate of about 20%.

Table 1.11: RUPIAH TIME DEPOSITS OF ALL BANKS BY OWNERSHIP,  
MARCH 1983-FEBRUARY 1985  
(Rp. billion)

	1983 March	1985 Feb.	% Change March 83- Feb. 85	% Contribution to deposit growth
Government & official entities	213	435	103.8	5.6
State enterprises	139	621	347.1	12.2
Insurance companies	287	666	131.9	9.6
Private enterprises	297	696	134.0	10.0
Individuals	856	2,737	219.7	47.4
Social foundations	442	835	88.7	9.9
Others	173	383	122.1	5.3
Total	2,407	6,373	164.7	100.0

Source: Bank Indonesia.

1.31 The growth in the state banks' time deposits has been accompanied by changes in the maturity structure of these deposits which have important implications for the state banks' lending operations (para 3.13 below). Before the June reforms, the bulk (92%) of the time and savings deposits of state banks consisted of 24 month deposits. After the reform, however, these longer maturity deposits declined sharply to only 9% of total time and savings deposits in December 1984. Initially, deposits of 1, 3 and 6 months maturity increased sharply, reflecting the narrow interest rate differentials among various deposit categories and expectations of exchange risks. In recent months, however, there has been a sharp increase in 12 month deposits which has again helped to offset to some extent the earlier less favorable trend in the maturity distribution of time deposits. Notwithstanding this recent growth of 12 month deposits the maturity structure of time deposits of state banks has shortened considerably from an average of 22 months in June 1983 to about 10 months in December 1984 (Table 1.12).

Table 1.12: MATURITY DISTRIBUTION OF STATE BANKS' TIME DEPOSITS,  
MAY 1983-DECEMBER 1984  
(In percent)

Category	May 1983	June 1984	December 1984
3 months & below	0.9	17.1	15.8
6 months	3.0	22.9	18.7
12 months	4.5	47.1	56.2
24 months	91.6	12.9	9.3
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
Average maturity - months	<u>22.7</u>	<u>10.5</u>	<u>10.4</u>

Source: Bank Indonesia.

1.32 The slower growth of demand deposits relative to time deposits is likely to be a permanent one reflecting a change in asset preferences between demand deposits and time deposits and between time deposits and other forms of savings given the factors noted above. As such it has a number of implications for the banks and for the authorities in the conduct of monetary policy. As far as the banks are concerned, this shift has resulted in a further increase in their average cost of funds, since banks generally pay little or no interest on demand deposits (para 3.4). As far as the monetary authorities are concerned, this shift has resulted in some reduction in demand for banks reserves, since Bank Indonesia sets lower reserve requirements for time deposits than demand deposits. This reduction in the demand for reserves has important implications for liquidity management by Bank Indonesia (Chapter 2 below).

1.33 The shortening of the maturity structure of state banks' time deposits (para 1.31) has important consequences for longer term lending. Given their dependence on relatively short term deposits, Indonesian banks try to match their loan portfolios with the maturity structure of their deposits by lending short term and keeping within prudent limits the proportion of long-term lending which they undertake with their own resources. In the past the Government has been able to overcome this problem by providing long-term credits through Bank Indonesia's liquidity credit mechanism. However, in the future the banks are expected to depend on their own resources for funding long-term loans. Therefore, measures will be necessary to encourage term lending by banks and to improve their maturity structure as discussed in Chapters 3 and 4 below.

## Chapter 2

### MANAGING MONETARY AND CREDIT POLICIES IN THE MEDIUM TERM

#### A. Introduction

2.1 The previous chapter reviewed the recent developments in the financial sector and the initial impact of the financial sector reform on the banking system. Although the impact of the reform has been by and large beneficial, some important issues with regard to the management of monetary and credit policies, the cost of credit and the availability of long-term funds for investment (through the commercial banks, the development banks and the capital market) have surfaced.

2.2 This chapter reviews the constraints which Bank Indonesia faces in regard to monetary management and credit policy referred to above. Issues related to the cost of credit and the availability of long-term funds through the commercial banks, specialized development banks and the capital market are discussed in the next three chapters.

#### B. The Open Capital Account and its Implications for Monetary and Credit Policies

2.3 One of the most important features of the Indonesian financial system is that the capital account is open; the Rupiah is freely convertible, and there are no controls on transferring funds, holding assets abroad, or borrowing from abroad by individuals, private firms, and domestic banks. (The only significant restriction is on foreign borrowing by public agencies, which is controlled by the Government. However, public agencies, as well as individuals and private companies, can and do hold foreign currency deposits with domestic banks.) The open capital account has been a feature of the Indonesian economy for nearly twenty years. Faced with growing foreign exchange constraints the Government in June 1983 deregulated deposit and lending rates of state banks partly to reduce capital flight and possible losses of official reserves. Although the reform has increased the responsiveness of domestic interest rates in Indonesia to developments in financial markets abroad, it has not changed the way in which the open capital account influences the Indonesian financial system.

2.4 The open capital account plays an important role in the determination of domestic interest rates and portfolio choices by banks, individuals and companies. Interest rates abroad now set a floor for domestic deposit and inter-bank rates.<sup>/1</sup> In addition, expectations of exchange rate changes raise this floor level since, to the extent that the Rupiah depreciates vis-a-vis the US dollar, holders of foreign assets make gains, in Rupiah terms, over and above the interest earned on their foreign assets. Domestic deposit rates, after adjusting for transaction costs, cannot generally fall below the floor set by international interest rates and exchange rate expectations because

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<sup>/1</sup> Except if the Rupiah is expected to appreciate vis-a-vis the US dollar.

depositors can freely transfer funds abroad. There are of course other factors such as convenience, access to facilities for borrowing from domestic banks, etc. which influence depositors' decisions to hold assets at home or abroad. Nevertheless, the risk of capital flight restricts the ability of domestic banks and the authorities to reduce domestic deposit rates, except to the extent that the latter can influence expectations of exchange rate risks (see below). These deposit rates, together with intermediation costs in Indonesia, in turn determine domestic lending rates.

2.5 Among the major factors which influence the formation of expectations on exchange rate risks in Indonesia are (a) differential inflation rates and (b) uncertainties with regard to future oil price movements. The authorities can gradually change perceptions of exchange risks associated with inflation differentials between Indonesia and trading partners through prudent monetary and fiscal policies. To the extent that these policies slow down domestic inflation and inflationary expectations, the nominal and real levels of interest rates could be lowered. However, the authorities have little control over oil price movements. Since oil revenues account for 70% of Indonesia's export revenues, movements in oil prices have a crucial bearing on the balance of payments, foreign exchange reserves, budgetary revenues and the exchange rate; and unfavorable oil price movements can circumscribe the authorities' ability to lower domestic interest rates through monetary and fiscal policies. Indeed, in recent months increased uncertainties with regard to international oil prices and associated perceptions of increased foreign exchange risks have kept nominal interest rates in Indonesia at high levels; and as domestic inflation abated, real lending rates have risen quite sharply (para 3.8).

2.6 Thus, given the open capital account, there are severe limitations on the scope for reducing interest rates in Indonesia by official actions independent of developments with regard to international interest rates and oil price movements. A second implication of the open capital account, apart from the linkage of domestic interest rates to international interest rates, is that the scope for the authorities to use monetary policy to stimulate real investment and output is limited. In contrast to a closed economy, given Indonesia's open capital account, monetary policy is likely to affect international reserves more than it affects real output. Thus, the monetary authorities face a potential long run trade-off between credit expansion and international reserve accumulation.

2.7 In the past Bank Indonesia has had only limited capacity to offset the impact of an expansion of its direct and indirect credits on reserves through open market operations. This is because there was (and still is) no market in government paper, as the Government has been a net supplier of funds to the banking system. In February 1984 Bank Indonesia began to issue its own certificates (SBIs) in order to mop up excess liquidity of banks. More recently Bank Indonesia introduced a new instrument - Money Market Securities (MMS) - which is designed to inject liquidity into the banking system (para 2.19) but which could also be used for mopping up domestic liquidity once an adequate stock of such securities has been built up by Bank Indonesia. Until such time the absorption of excess liquidity would remain a somewhat difficult task. For example, over the medium term it will be difficult to sustain a policy of selling additional SBIs to mop up the excess domestic liquidity.

Since the interest rate on SBIs would be higher than the present rate on liquidity credits, this operation would result in a net loss to Bank Indonesia. Over the long term losses to Bank Indonesia from such a policy could be substantial.

2.8 Implications for Medium Term Monetary Programming. The foregoing analysis brings out some important implications for monetary and credit policy. Firstly, in view of the potential trade-off between foreign exchange reserves and credit expansion, from a medium term perspective Bank Indonesia needs to manage carefully the growth of its direct and indirect credits. Given Bank Indonesia's objectives of maintaining an orderly expansion of domestic credit, reducing domestic inflation, and sustaining an appropriate level of foreign exchange reserves, the extent to which Bank Indonesia could increase credit over the medium term without jeopardising these goals will depend on the future demand for base money and the growth of government deposits with Bank Indonesia (see below). These limitations on the overall availability of Bank Indonesia credits, in turn, constrain the extent to which priority credit programs can be funded through BI credits. Thus, the Government would need to increase its net deposits with Bank Indonesia in real terms to enable Bank Indonesia to fund the projected level of demand for liquidity credits from priority programs in the medium term. If Government deposits with Bank Indonesia were to decline, or if the implementation of priority programs were to be faster than envisaged in this report, or new priority credit schemes are established, then Indonesia's foreign exchange reserves could come under pressure (paras 2.11-2.17). Secondly, the special credit programs have an implementation pattern of their own, which might not necessarily be consistent with the short term liquidity needs of the economy. In order to ensure a smooth expansion of credit, therefore, the authorities may need to utilize existing monetary control instruments more flexibly and to consider developing additional instruments for smoothening domestic liquidity growth (paras 2.18-2.20).

2.9 Availability of Bank Indonesia Credit. Broadly speaking, Bank Indonesia is able to fund its additional credits from two main sources: (a) through increases in base money /1, and (b) through increases in government deposits with Bank Indonesia, representing financial savings and net foreign borrowings of the Government which are available for onlending to other domestic borrowers. During 1979-83 net government deposits (deposits minus borrowing from Bank Indonesia) increased by Rp. 3.4 trillion, and the money base by Rp. 3.1 trillion, accounting for the bulk of Bank Indonesia's funds (Table 2.1). Changes in Bank Indonesia's other liabilities (net) accounted for only 6% of its new funds over this period./2

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/1 Base money is defined as Rupiah currency held by the public, currency held by the banks and deposits of banks with Bank Indonesia.

/2 Bank Indonesia's profits after tax are the most stable source of funds in this category .

**Table 2.1: BANK INDONESIA SOURCES AND USES OF ADDITIONAL FUNDS, 1979-83**  
(Rp. billion; End December)

	1979	1980	1981	1982	1983	Total 1979-83
<b>Sources</b>						
Change in net govt. deposits	631	1,426	368	(300)	1,299	3,424
Change in money base	551	881	556	205	888	3,081
Change in other liab. (net)	184	186	(115)	758	(572)	441
Total sources	1,366	2,493	809	663	1,615	6,946
<b>Uses</b>						
Bank Indonesia credits	499	884	1,019	1,318	208	3,928
Net foreign assets	867	1,609	(210)	(655)	1,407	3,018
Total uses	1,366	2,493	809	663	1,615	6,946

Figures within brackets indicate reductions.

Source: Bank Indonesia.

2.10 Given these funding sources Bank Indonesia can either (a) increase its holdings of foreign assets /1 (foreign exchange reserves) /2, or (b) expand its domestic asset holdings (principally direct credits or credits to the banking system). During 1979-83 Bank Indonesia increased its credits by Rp. 3.9 trillion and net foreign assets by Rp. 3.0 trillion (Table 2.1). There were of course significant year-to-year variations in these aggregates. Nevertheless, for the period 1979-83 as a whole the expansion in Bank Indonesia's credits was closely matched by increases in net government deposits with Bank Indonesia.

/1 Bank Indonesia can increase its foreign assets, since if there is an increase in demand for base money which is not validated by an increase in Bank Indonesia credits, the banks can only obtain additional free reserves from Bank Indonesia by selling their foreign exchange. Similarly, since the bulk of government revenues are foreign exchange (oil export revenues) and foreign borrowing, while most of its expenditures are in Rupiah, an increase in its financial surplus with Bank Indonesia is generally matched by a similar amount of foreign exchange.

/2 The determination on an appropriate level of foreign reserves is a matter of considerable judgement. In Indonesia's case it is generally accepted that a prudent foreign reserve management policy calls for maintaining a reasonably high level of reserves to protect the convertibility of the Rupiah and cushion the economy from possible short term changes in its terms of trade and oil export revenues. Once this reserve target is met, Bank Indonesia can use the remainder of its funds to either purchase additional foreign exchange reserves or increase domestic credit.

2.11 Looking to the future, the extent to which Bank Indonesia could increase its credits without jeopardising its monetary, inflation and reserve targets will depend on the growth of demand for base money and government deposits with Bank Indonesia on the one hand, and the desired increase in foreign exchange reserves on the other. In order to make some judgements in this regard, projections of the growth of the monetary aggregates and money base were made which are summarized in Table 2.2 below. The details of the assumptions underlying the projections and the methodology are contained in Appendix 1. The key assumptions are that: (i) GDP growth would average close to 5% p.a. over the 1984-88 period and the inflation rate would gradually decline from 9% in 1984 to 6% by 1988 (as assumed in Repelita IV), (ii) Indonesia's net official foreign exchange reserves will rise by an additional \$2.8 billion over December 1984 levels by 1988 in line with the projections made in the recent World Bank economic report on Indonesia /1; (iii) a continuing modest increase in financial deepening will occur (with M1 and M2 in real terms growing by 5.7% and 7.7% p.a. respectively between 1984-88). Separate projections of the Government budget were not made by the

Table 2.2: AVAILABILITY AND DEMAND FOR ADDITIONAL BANK INDONESIA CREDITS, 1984-88 (Rp. billion)

	1984 Actual	1985 -----	1986 Projected	1987 -----	1988 -----	1984-88 Total
<u>Changes over previous year</u>						
Money base	592	635	815	948	1,027	4,018
Other liabilities (net)	341	205	196	183	165	1,090
Net foreign assets (-increase)	<u>-1,975</u>	<u>-175</u>	<u>-531</u>	<u>-1,103</u>	<u>-1,046</u>	<u>-4,830</u>
Credit from BI sources	-1,042	665	480	28	146	277
Net Government deposits						
Variant I /a	2,129	-	-	-	-	2,129
Available credit (I)	1,087	665	480	28	146	2,406
Net Government deposits						
Variant II /b	2,129	557	534	497	448	4,165
Available credit (II)	<u>1,087</u>	<u>1,222</u>	<u>1,014</u>	<u>525</u>	<u>594</u>	<u>4,442</u>

/a Net Government deposits remain constant in nominal terms over 1984-88 period.

/b Net Government deposits remain constant in real terms over 1984-88 period.

Source: World Bank staff estimates and projections.

/1 Such an increase will maintain Indonesia's foreign exchange reserves at the equivalent of 7 months' imports over the 1984-88 period. See World Bank Report No. 5597-IND: "Indonesia - Policies for Growth and Employment", April 23, 1985.

present mission; however, in line with the analysis presented in the 1985 economic report on Indonesia, it is assumed that the Government's financial position will be significantly more constrained and, therefore, government deposits with Bank Indonesia will grow considerably more slowly in Repelita IV than during Repelita III. Accordingly two variants are assumed in regard to government deposits with BI. Variant I in Table 2.2 above assumes that, following the unexpectedly large increase of Rp. 2.1 trillion in government deposits which took place in 1984, there would be no further increase in government deposits in nominal terms over the next few years. Variant II, which is akin to a "high" case, assumes that government deposits with BI, in nominal terms, will continue to increase at the rate of domestic inflation (i.e., remain constant in real terms).

2.12 Table 2.2 shows the available level of new Bank Indonesia credit based on these assumptions. Thus, if government deposits with Bank Indonesia remain constant at their December 1984 level in real terms, the increase in net government deposits with BI (in current prices) would amount to about Rp. 4.2 trillion during 1984-88. However, if government deposits remain at their December 1984 levels, in nominal terms, the increase during 1984-88 will amount to only Rp. 2.1 trillion as compared to a net increase of Rp. 3.2 trillion during 1979-83. Thus, depending on the level of Government deposits, Bank Indonesia could increase its credits by between Rp. 2.4 trillion and Rp. 4.4 trillion during 1984-88, after allowing for the assumed increase in foreign exchange reserves.

2.13 Demand for Bank Indonesia Credit. In order to ascertain whether the demand for credit from the special credit programs is broadly consistent with the available supply of Bank Indonesia credit, projections of the likely demand from priority programs were also made. These projections are summarized in Table 2.3 below.

2.14 The largest individual special credit programs are permanent working capital credits to small scale industries (KMKP), investment credits to small scale industries (KIK), housing credits (through BTN) and lending to the tree crops sector. Ten other smaller schemes, including BIMAS, accounted for the remaining 25% of the value of Bank Indonesia's outstanding credit in early 1984. The on-lending rate to new borrowers under the priority programs currently ranges between 5 and 12%, with the majority of new credits extended at 12%. The tree crop program for smallholders also has a relatively long grace period which effectively reduces the interest rate. Depending on the program Bank Indonesia rediscounts between 70 and 100% of the value of bank loans at a rate of 3%./1 In addition, credits to BULOG have been included since it is expected that Bank Indonesia will continue to provide new credits to BULOG during REPELITA IV. At the beginning of 1984, credits to BULOG amounted to Rp. 1.1 trillion. The bulk of this amount is lent by banks at 6% and rediscounted by Bank Indonesia at 4%.

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/1 The exception is the general village credit scheme (KUPEDES) where Bank Indonesia rediscounts 100% of the value of the loan at 15%.

**Table 2.3: DEMAND FOR BANK INDONESIA CREDIT, 1984-88 /a**  
(Annual change in Rp. billion; end December)

	1984 Actual	1985 -----	1986 Projected	1987	1988 -----	1984-88
Credit demand						
Estate crops	96	200	250	325	400	1,271
Housing	152	150	200	275	350	1,127
KIK/KMKP	-23	100	150	220	280	727
Export credits	239	100	108	116	124	687
BULOG /b	532	170	187	206	226	1,321
Other priority	91	161	173	184	194	803
<u>Total</u>	<u>1,087</u>	<u>881</u>	<u>1,068</u>	<u>1,326</u>	<u>1,574</u>	<u>5,936</u>

/a From special credit programs existing in 1984 only; excludes possible changes in the level of BI credit associated with non-priority programs and direct BI lending to public enterprises.

/b Net increase in BULOG credits (which were transferred from BI direct credits to public sector agencies to indirect credits to banks in March 1984).

Source: World Bank staff estimates and projections.

2.15 In projecting the demand for new Bank Indonesia credits during the period 1984-88, it is assumed that no new priority programs are created over the next few years. Second, individual projections for the four main priority credit programs - housing (BIN); small scale industrial credits (KIK/KMKP); tree crops and export credits as well as credits to BULOG) - are based on World Bank staff assumptions about the potential scale of demand for credits under these programs. (These estimates are broadly in line with Government estimates.) Third, it is assumed that the remaining priority programs /1 will increase in line with the projected real growth of the economy. Fourth, possible credit demand associated with non-priority programs and direct lending by Bank Indonesia to certain public sector enterprises is not included, as this could be changed as a matter of Bank Indonesia policy.

2.16 These projections have, of course, to be interpreted with some caution. It is extremely difficult to forecast the disbursement rates for the special programs and implicit judgements have been made on both the potential demand for credits and program implementation. For example, it is assumed that implementation rates for several priority programs will pick up

/1 The Government has announced its intention to phase out the BIMAS program by FY85/86 at the latest. This should not affect the overall demand for priority credit significantly, however. Farmers currently covered by BIMAS program would be eligible for credits under the village credit program.

substantially and rather smoothly from the rates recorded in 1984. Past experience however shows that year to year progress is often uneven for a variety of factors.<sup>/1</sup> The projection should therefore be taken as a broad indication of the potential scale of demands which may be made on Bank Indonesia in the years ahead. For the five year period 1984-88 the potential credit demand from the present special credit programs is projected at Rp. 5.9 trillion.

2.17 These projections indicate that the demand for special credits from ongoing programs is likely to be substantially higher than the projected availability of Bank Indonesia credits. For example, under Variant I (i.e. no increase in government net deposits in current prices with Bank Indonesia), BI would be unable to fund the projected demand for credit in each of the next few years without endangering its monetary and reserve targets, unless the Government increased its net deposits. Even if net government deposits were to remain constant in real terms (Variant II), there would be a cumulative excess demand from the special credit programs of about Rp. 1.5 trillion during the 1984-88 period. Under this scenario, from about 1987 onwards the demand for priority credits would begin to substantially exceed the available credit from BI and the projected level of net government deposits. This suggests that, looking towards the future, there are important limitations on the pace at which BI should fund new priority credit programs. Consequently, it would appear inadvisable to introduce any new priority credit schemes at this juncture. Before the end of REPELITA IV, BI could find itself hard-pressed to fund even the current priority credit programs.

2.18 Coordinating Fiscal and Credit Policies and Improving Liquidity Management. The projections illustrate another important point. As noted earlier, the behavior of government deposits is an important determinant of the prudent level of domestic credit creation by Bank Indonesia, and there is, therefore a need to carefully coordinate fiscal and credit policy. However, the behavior of government deposits will not necessarily be consistent with the liquidity needs of the economy. Such an imbalance could arise if government deposits increase more rapidly than envisaged in Variant II of Table 2.2 above, and/or if the level of demand for priority credits were to fall short of the levels envisaged in Table 2.2, or fluctuate according to the rate of implementation of these programs. Indeed, some programs such as KIK and KMKP are cyclical in nature and are poor vehicles for channeling liquidity into the banking system in an orderly manner.

2.19 Bank Indonesia possesses a number of monetary policy instruments (other than the liquidity credit mechanism) to regulate bank liquidity. However, as noted, the use of open market operations is constrained by the fact that in Indonesia the Government is a major net creditor to the banking system; and Bank Indonesia cannot regulate the money base by purchases and sales of government debt. The creation of SBIs (2 week to 3 month bills) by Bank Indonesia will help in principle to partly remedy this shortcoming, since

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<sup>/1</sup> In the case of KIK/KMKP, for example, the rate at which future loans are taken up will be influenced by overall business conditions. In the case of other programs, such as smallholder estate development and the housing program, the rate of project implementation will be a key factor in determining credit demand.

Bank Indonesia can reduce domestic liquidity by selling these bills either to the DMBs or the public. However, the average outstanding stock of SBIs in the hands of the banks and the public is still small; and until this increases significantly, there is little scope for injecting additional liquidity by repurchasing SBIs. Bank Indonesia could also inject additional liquidity into the banking system by lowering reserve requirements; however such lowering is likely to be a one-time adjustment only. Moreover, it may not be appropriate on occasions for reasons of financial prudence, given the variations in the financial condition of banks. In view of these limitations, Bank Indonesia recently announced a new instrument - Money Market Securities (MMS) - in order to inject liquidity into the banking system by purchasing promissory notes from banks and non-bank financial intermediaries.<sup>/1</sup> This new scheme has already had a salutary effect on money market conditions. There is also scope to use the traditional central banking instruments more frequently than in the past, and it is important that these instruments are used more flexibly in order to facilitate the Central Bank to regulate bank liquidity. In addition, there is a possible need in the future for additional instruments for injecting liquidity into the banking system.

2.20 One possible instrument which Bank Indonesia might wish to consider would be to purchase CDs of appropriate maturities from the banks in amounts which are consistent with monetary base management. The rate of interest on these should be determined by market forces. However, as in the case of the SBIs, the first few sales could take place at preannounced interest rates. Later, as experience is gained, Bank Indonesia could move to an auction system. The CDs could be made saleable in the inter-bank market both to increase the flexibility of monetary authorities to influence market conditions, and to help widen the range of instruments in the inter-bank market. Such an arrangement has the virtue of being relatively easy to implement. It would not require the creation of new administrative units to approve the use of such funds, as is the case with special programs. The banks should be free to determine for themselves how these funds should be used, and consequently such a system would not interfere with the lending decisions of banks based on market considerations. Nor would the disbursement of these resources be tied to the implementation schedule of particular credit programs. To the extent that these CDs are of longer maturities they would also help improve the maturity structure of the DMBs' deposit base (para 1.31 above), and encourage the banks to become more active in term lending (see para 3.32).

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<sup>/1</sup> Under this new scheme, which became effective on February 1985, Bank Indonesia will buy MMS directly from banks and NBFIs or through designated security houses. Three types of MMS are eligible for discounting: promissory notes issued by banks and NBFIs in borrowing from the interbank market; those issued by customers of banks and NBFIs based on lines of credit from such institutions; and trade bills based on underlying transactions issued by third parties and endorsed by banks and NBFIs. The MMS have a maturity range of 30-90 days, while the discount rate is set by Bank Indonesia according to market conditions; (at present, the discount rate on MMS is 19.5% p.a.).

2.21 A variation of the same approach, in a situation where government deposits increase, would be for the Government to place long-term deposits directly with banks. While this would help improve bank liquidity, such direct placement would be less desirable from the viewpoint of monetary management. It will make the task of liquidity management by the monetary authorities more difficult. Indeed, direct placement could weaken the role of the Central Bank in conducting monetary policy and should therefore be avoided.

### C. Financing of Special Credit Programs

2.22 The major conclusion of the above analysis is that, in view of the uncertainties with regard to the availability of Bank Indonesia credits, priority programs to be financed by such credit should be limited. There should be a careful scrutiny of these programs. In addition, credit subsidies should be limited to those programs for which a strong case can be made on economic grounds. Moreover, efforts should be made to transfer more responsibility for funding these programs to the banks. However, banks will require incentives to undertake such a role. Lending rates for special programs therefore will need to be raised. In certain cases where direct interest rate subsidies may be justified, these could be channeled through the budget in order to make them transparent and to reduce the cost of subsidies. These issues are already under consideration by the Government./1

### Bank Indonesia Credit Subsidies.

2.23 Credit subsidies provided by Bank Indonesia to special programs through low interest loans to banks (who in turn channel such loans into priority programs at mandated lending rates) have been substantial. For the period 1978-82 the average rate charged by BI on credits to the banking system ranged between 1.8 and 3.4% (Table 2.4). For direct credits the rates charged by BI ranged between 1.1% and 4%. These rates were significantly below the rate of inflation during this period, implying sharply negative real interest rates. For 1983, however there was a rise in the level of nominal and real interest rates paid on both direct and indirect credits. Interest rates paid on indirect credits increased to 4.3% and for direct credits to 7%. Since consumer prices rose by 12 percent in 1983, this meant that the average real interest rate on BI lending for priority programs was still negative, -6.5 percent.

2.24 Although Bank Indonesia provided these low interest loans, the costs of implicit credit subsidies have been effectively borne by the Government. As noted earlier, government deposits are an important source of low cost funds to Bank Indonesia for funding priority programs; and Bank Indonesia does not pay any interest on these government deposits. The interest rates at which Bank Indonesia relends these government deposits constrain BI's ability to pay interest on government deposits; and thus involve budgetary costs. If Bank Indonesia were to raise its lending rates to special programs it could

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/1 Proposals are under consideration to encourage the banks to finance a larger share of these programs, and for certain programs to expand the use of direct interest subsidies financed through the budget to banks.

pay interest on government deposits and augment government revenues by an equivalent amount. Moreover, these low lending rates directly affect BI's overall profitability; and since BI pays half of its profits to the Government in the form of taxes, there is a direct impact on government revenues.

**Table 2.4: BANK INDONESIA AVERAGE LENDING RATES AND IMPLICIT ANNUAL SUBSIDIES ON BANK INDONESIA CREDITS, 1979-83**

	1979	1980	1981	1982	1983	1979-83
Average lending rates <u>/a</u>						
Credits to banks	3.4	1.8	2.8	3.2	4.3	3.3
Direct credits	1.1	1.4	1.8	4.0	7.4	3.7
Total credits	1.8	1.7	2.5	3.7	5.9	3.4
Average inflation rate <u>/b</u>	24.0	17.1	7.3	10.0	12.0	13.9
Implicit subsidy c.f. 13% average lending rate (Rp. billion) <u>/c</u>	342	424	481	577	466	2,290

/a Based on comparison of average quarterly outstanding credits and Bank Indonesia interest income.

/b Consumer Price Index (Dec.-Dec.).

/c Difference between actual and hypothetical interest rate revenues.

Source: Bank Indonesia, BPS, and World Bank staff estimates.

2.25 An indicator of implicit government subsidies is the additional interest rate revenues Bank Indonesia would have received had it made its credits available at an average rate of 13% on both direct and indirect credits and used such revenues to pay interest on government deposits (Table 2.4).<sup>/1</sup> These implicit subsidies have been substantial rising from Rp. 342 billion in 1979 to Rp. 577 billion in 1982 in current prices and amounted to Rp. 2.3 trillion during the 1978-83 period. Since Bank Indonesia raised interest rates during 1983, however, the implicit subsidy declined to Rp. 466 billion in that year. These are substantial amounts relative to Government non-oil tax revenues (estimated at Rp. 5.5 trillion in FY1984/85). Over time, without further increases in Bank Indonesia interest rates this subsidy will continue to rise in line with the growth of Bank Indonesia credits.

<sup>/1</sup> It could be argued that to the extent that the build up of Government deposits was financed by foreign borrowing on commercial terms the implicit subsidies were even larger.

2.26 Projected Level of Subsidies. Although Bank Indonesia cannot reduce the level of subsidies implicit in the past credits it has granted, it can influence the level of subsidies extended under future programs. Table 2.5 shows the future subsidy implications of the projected demand for Bank Indonesia credits on the assumption that the opportunity cost of Bank Indonesia's funds is at least 4% in real terms.<sup>/1</sup> Given Bank Indonesia's inflation targets, this translates into a nominal rate of 13% during FY85/86 declining to 10% by FY1988/89. On this basis, the implicit subsidy on new Bank Indonesia credits would amount to Rp. 1.3 trillion during the next 4 fiscal years. Loans to BULOG account for the bulk of these subsidies. Taking into account implicit subsidies on the existing stock of liquidity credits, the total credit subsidies under existing and future programs over the next 4 fiscal years would amount to about Rp. 2.2 trillion.

Table 2.5: PROJECTED ANNUAL BANK INDONESIA CREDIT SUBSIDIES ON NEW CREDITS BY PROGRAM, FY85/86-FY88/89 <sup>/a</sup>  
(Rp. billion, current prices)

	FY85/86	FY86/87	FY87/88	FY88/89	Total FY85/86-FY88/89
Estate crops	6	25	45	66	112
Housing	11	25	41	60	137
KIK/KMKP	8	23	43	62	136
BULOG	187	187	185	181	740
Export credits	6	10	15	18	49
Other priority	6	21	35	45	107
Non priority	0	0	0	0	0
Direct credits	0	0	0	0	0
<u>Total</u>	<u>223</u>	<u>291</u>	<u>363</u>	<u>432</u>	<u>1,279</u>

<sup>/a</sup> Excludes budgetary transfers and direct credit subsidies.

Source: World Bank staff estimates.

2.27 Suggested Policy Reforms. Given the potential demand for priority credits and the scale of the implicit credit subsidies, there is a need for reexamining the priority credit programs. As a medium term policy goal, three of the weaknesses of the present system could be addressed: the dependence of the priority credit programs on Bank Indonesia funding, the lack of incentives for banks to assume greater responsibility for financing these programs, and the lack of a clear link between the subsidies given to borrowers and their economic circumstances.

<sup>/1</sup> Inflation adjusted yields on long term government securities (which Indonesia would hold in its foreign exchange reserve portfolio) ranged between 4% (France, West Germany, Japan and the UK) and 8% (USA) during most of 1984; (IMF "World Economic Outlook", 1984).

2.28 These priority programs now depend heavily on Bank Indonesia's liquidity credits for funding. As emphasized earlier, the extent to which Bank Indonesia could prudently fund these programs will depend largely on the growth of net government deposits. If government deposits do not increase sufficiently, or if the implementation of these programs were to pick up, or if new priority programs are undertaken, Bank Indonesia may not have the capacity to finance all these programs. Under such circumstances, Bank Indonesia might have to curtail its financing of priority programs in order to meet its monetary goals.

2.29 There are other compelling reasons for reexamining the present liquidity credit mechanism for financing priority programs. To the extent that priority programs are given preferential access to credit (through liquidity credits), it will entail certain costs. Preferential access of priority programs to Bank Indonesia credits, for example, will preempt resources from alternative activities and investments. Heavily subsidized lending rates under these programs also could lead to misallocation of resources, as has been the case with some programs in the past. It is therefore important that the priority programs which are to be eligible for preferential financing are limited to carefully defined and monitorable programs for which a strong case can be made, the scale of subsidies for these programs is progressively reduced, and alternative mechanisms of providing subsidies to eligible programs be considered in order to achieve desired objectives (see below).

2.30 Moreover, under the liquidity credit scheme there is little inducement for banks to commit more of their own resources to priority programs. Banks receive low cost funds from Bank Indonesia, which they then blend with their own higher cost funds in order to make credits available to borrowers at below market rates while assuring minimum margins to banks. Consequently, from the point of view of their own profitability, there is an incentive to banks to keep to a minimum the proportion of funds they contribute to these programs. However, if these programs are deemed to be high priority, banks should be encouraged to fund a higher proportion of these programs from their own resources. But if the banks are to contribute more of their own resources to the funding of priority credit programs, either interest rates on priority credits must be increased or direct interest rate subsidies may have to be provided to the banks.

2.31 Two arguments could be made for the continuation of some interest rate subsidies. First, the nature of the credit schemes imposes additional costs to the banks, because of the administrative expenses involved in meeting the requirements of the programs. If the priority credit borrowers had to shoulder the full burden of these administrative costs, the rate they would have to pay would be very high. Moreover, the state banks have relatively high intermediation costs. This is partly due to past interest rate policies, as well as the liquidity credit system, which blunted the incentive for them to keep costs under control. However, the state banks will only be able to reduce their intermediation costs over a medium term horizon (para 4.50). Thus, particularly in a period of transition, there is a case for a modest subsidy to priority program borrowers until the banks can reduce their intermediation costs.

2.32 The second argument for subsidies rests on grounds of equity. One of the main aims of the priority credit programs is to help the weaker economic groups and poorer sections of society. In order to meet these goals the credits must be affordable and not impose an unduly high debt service burden on the borrowers. At present subsidised rates, borrowers under priority programs now pay positive real interest rates. However, these arguments in no way vitiate the case for limiting subsidies and targeting subsidies to the needy. In view of the constraints, already noted, on financing these programs and high real interest rates elsewhere in the economy, it is important that the costs of these schemes are limited, and balanced against the extent to which they reach the target groups and the circumstances of individual borrowers. Analysis by World Bank staff suggests that for the major schemes - KIK/KMKP, tree crops and housing - effective onlending rates to individual borrowers could be increased further and, in the case of tree crop loans to smallholders, grace periods reduced, without significantly eroding the goals of these programs. A reduction in these subsidies would free resources for other programs. Consequently, the policy issue facing the Government is to weigh the costs of the substantial subsidies implicit in the special credit programs against the need to mobilize resources to meet its other development objectives.

2.33 The existing liquidity credit mechanism in the case of most priority programs is fairly simple to operate, the banks have experience with it and the final costs to the borrowers are reasonable. However, there are strong arguments for change. Firstly, the liquidity credit system does not provide any incentive for the banks to mobilize resources to fund special programs. Secondly, there is no clear incentive for the banks to reduce their intermediation costs. Thirdly, the implicit costs to society of subsidies provided under such a system are not very obvious. It is therefore highly desirable to reduce such subsidies and to gradually replace the implicit subsidies currently provided through liquidity credits with a system of explicit interest rate subsidies provided through the budget, where subsidies are justified. Such an arrangement makes the costs more transparent, brings to bear pressure to reduce subsidies, and helps to overcome the problems mentioned above.

2.34 One of the main advantages of direct budgetary subsidies is that they are more flexible than liquidity credits. Direct subsidies can be more readily adjusted to changing macroeconomic conditions than (fixed interest) Bank Indonesia credits. For example, if the average costs of bank funds change from one year to the next, budgetary subsidies can be adjusted accordingly to reflect these differences. This can offer some degree of protection to the banks from the problem of interest rate volatility, and help overcome the reluctance of banks to lend long term. On the other hand, if interest rates decline subsidies can be lowered, thereby permitting budgetary savings.

2.35 Another advantage of budgetary subsidies is that they would provide a better instrument for promoting more efficient intermediation on the part of the banks. As already noted the state banks face a difficult period of transition. It will take time for these banks to reduce their intermediation costs and improve efficiency. A budgetary subsidy would assist the banks to

cope with the problems of adjustment while keeping costs to priority borrowers reasonable. Such a strategy implies developing a specific timetable for reducing the size of the budgetary subsidy over time to take into account the expected progress the banks would be required to make in reducing intermediation costs.

2.36 A reform of the priority credit programs should involve three elements. First, onlending rates on the priority credit programs should be increased. Without such increases it will not be profitable for the banks to increase the share funded from their own resources in priority credits. The Government is already moving in the direction of increasing onlending rates, and this policy needs to be continued. Such increases in onlending rates should be considered, for example, for the KIK/KMKP program. In this program there is a strong case for raising the onlending rate from 12% currently to at least the same rate as paid on the TABANAS small savings scheme (15%). There are also good arguments for increasing onlending rates to smallholders in the tree crops sector programs in order to remove the disincentive for early repayment of loans. The real financial rates of return under these schemes are very attractive for the smallholders and moderate increases in lending rates would be unlikely to reduce the demand for such credit. In the case of smallholders, credit costs are not fully capitalised during the grace period before the trees come into production which considerably reduces the nominal effective rates. As an initial step these credit costs should be fully capitalised. Consideration should also be given to increases in the onlending rate on tree crops projects to 15%.

2.37 The second element should be to increase the discount rate on Bank Indonesia priority credit programs. Such a change should be implemented gradually over the remainder of REPELITA IV. At the same time Bank Indonesia should begin to pay interest on government deposits in line with the increase in its discount rate. Initially the impact of the increase in Bank Indonesia's discount rate should be fully offset by a direct government interest rate subsidy on priority credit programs. There would be no net impact on the government budget as a result of such a change, since the cost of the direct credit subsidy would be financed from the payment of interest on government deposits with Bank Indonesia. However, as a result of this change by the end of REPELITA IV interest rate subsidies could be shifted from implicit Bank Indonesia liquidity credit subsidies to direct budgetary subsidies. This would enable the costs of such schemes to be measured more clearly.

2.38 The third element of the strategy should be to aim for a gradual reduction in the proportion of priority credits discounted by Bank Indonesia. Again the timing and pace of such a shift should be determined on the basis of overall monetary considerations, with a view to maintaining Bank Indonesia's flexibility in liquidity management.

#### D. Financing Public Enterprise Investment

2.39 Another important aspect of credit policy relates to the financing of public enterprise investment through bank credit. During REPELITA III public enterprises relied on a mixture of funding to finance their investment programs. These sources included retained earnings, government equity contributions, borrowing from Bank Indonesia and the DMBs as well as foreign borrowing and bond issues. As a matter of policy the Government now expects public enterprises to rely more heavily on the domestic banking system (and to a certain extent bonds) to fund their future investments. While the Government will continue to provide direct financial contributions to some programs, it is intended that government equity contributions will be kept to a minimum and are to be used as a "last alternative" after other means have been explored. This raises two interrelated financial policy concerns: First, whether the public enterprises can afford to borrow on commercial terms at prevailing interest rates; Second, whether the domestic banking system can meet these needs as well as those of the private sector, or whether the latter will be "crowded out" of the market for term finance.

2.40 The financial position of public enterprises varies greatly. Some are currently highly profitable; others have been making losses or barely breaking even for a number of years. As a group, these enterprises have been profitable over the last five years (Table 2.6). On a net basis, Government equity contributions exceeded dividends and corporation taxes paid to the Government by a slight margin during these years. (Consequently, financing investment of public enterprises has not been a major source of strain on the Government budget).<sup>/1</sup> The profits and retained earnings data, however, include those of Bank Indonesia and state banks; and according to World Bank staff estimates these banks accounted for about 55% of public enterprises' profits in 1983. Moreover the profitability of public enterprises has been declining over time, both in relation to total assets and income. This apparent deterioration in the financial performance of public enterprises is of particular concern when viewed against the Government's desire to encourage these enterprises to resort to more commercial bank financing.

2.41 Over the 1979-83 period net public enterprise borrowing from the banking system amounted to about Rp. 1.3 trillion at current prices. Government equity contributions totalled Rp. 2.1 trillion and enterprise retained earnings amounted to about Rp. 5.4 trillion. Even allowing for public enterprise borrowing abroad, these figures suggest that there was a substantial improvement in the overall debt equity ratios of public enterprises during this period. While this overall trend seems encouraging, it should be interpreted cautiously. As noted earlier, the inclusion of BI and state banks in Table 2.6 substantially improves the retained earnings of public enterprises as a whole; secondly, net borrowings of public enterprises include repayments of Rp. 530 billion between 1978/79 and 1983/84 by Pertamina of loans contracted under the 1974 rescue package. Thus the performance of other public enterprises (excluding the banking institutions and Pertamina's

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<sup>/1</sup> As opposed to direct budgetary subsidies to compensate enterprises for price controls on oil and fertilizer, which, as Table 2.6 shows, totalled Rp. 5.5 trillion during FY78/79-83/84.

debt repayments) is much less favorable. It is believed that, despite the high protection and sometimes the monopoly status given to public enterprises, a number of state enterprises in the manufacturing sector are only barely profitable or are substantial loss makers./1

Table 2.6: PUBLIC ENTERPRISES - SELECTED FINANCIAL INDICATORS, 1979-83 /a  
(Rp. billion)

	1979	1980	1981	1982	1983
Total assets	26,316	34,514	40,409	48,268	57,868
Sales	6,522	9,796	11,404	14,533	15,075
Profit before tax	1,179	1,422	1,628	1,329	1,684
Tax and dividend payments (FY)	181	295	365	497	528
Financing net capital formation /b					
Retained earnings	998	1,127	1,263	832	1,156
Government equity contributions (FY)	253	477	481	337	592
Net borrowing from domestic banks(FY)	113	384	398	402	38
Net foreign borrowing and off budget transfers	n.a.	n.a.	n.a.	n.a.	n.a.
<u>Memo items:</u>					
Return on assets (%)	4.5	4.1	4.0	2.8	2.9
Return on sales (%)	18.1	14.5	14.3	9.1	11.2
Net budget contribution (Rp. billion) /c	-72	-182	-116	161	-63
Budgetary subsidies (Rp. billion) /d	597	1,192	1,414	1,144	1,194

/a Including State Banks and Bank Indonesia; it is not known, however, whether the data for the banking sector have been consolidated or what is included in "sales" for the banking sector. Data for 1984 are not yet available.

/b Net capital formation does not equal change in total assets primarily because latter includes increase in assets of the financial system.

/c Excluding budgetary subsidies.

/d Subsidy on oil and domestic fertilizer production.

Source: Ministry of Finance, Bank Indonesia and World Bank staff estimate.

/1 One indication of the weak financial performance of these enterprises is that they accounted for almost half of the equity contributions made by the Government during REPELITA III. Although there is no information available concerning the distribution of these equity contributions between new investment and financial rehabilitation payments, it is believed that the bulk of such contributions fell in the latter category.

2.42 It is the Government's intention that public enterprises should acquire borrowed funds for investment and working capital at market terms. Given the recent sharp increases in interest rates, however, public enterprises will now have to pay at least 18% p.a. or higher on their borrowing, as compared to about 13% p.a. earlier; the proportion of debt, to be financed at such high rates, may also rise to the extent that government equity contributions and subsidized credit are reduced, and internal generation of funds by public enterprises is affected. Indeed, higher cost of credit itself may contribute to a worsening of the financial performance of public enterprises; a number of enterprises are reportedly facing cash-flow problems, while others, as noted, are already incurring losses. Thus, if the increased costs are not matched by corresponding increases in output prices or improvements in efficiency, the internal generation of funds and/or debt-equity ratios are likely to deteriorate. Indeed, the debt-equity ratios of some enterprises may not be appropriate to permit substantial recourse to bank borrowing at market rates.

2.43 Given the apparently weak financial position of a number of public enterprises, the authorities need to monitor very carefully the growth of public enterprise borrowing from the banking system. As noted in para 4.13, lending to state enterprises in the pulp and paper, cement and tire making sectors accounts for a high proportion of the bad debts and arrears problems of BAPINDO. These problems are indicative of the potential strains that excessive public enterprise borrowing can place on the banking system. As a matter of general policy, the Government and banks should ensure that only the strongest enterprises, with projects which can be funded on commercial terms, borrow from the banking system. In this respect the Government's "lender of last resort" approach needs to be clarified, because there is a possibility that it will lead to a greater than desirable amount of commercial debt financing by public enterprises. Public enterprises may feel under pressure to resort to commercial bank financing rather than develop financing plans which strike a more appropriate balance between equity and debt finance. In the past there have been cases where excessive debt financing by public enterprises has had to be refinanced through infusions of government equity. The Government should ensure that new investments do not strain the financial position of enterprises and where necessary increase the capitalisation of public enterprises before they undertake new investment.

2.44 Such a strategy is also consistent with the goal of maintaining the flow of credit to the private sector. Previous World Bank projections have suggested that on macroeconomic grounds an appropriate level of investment by public enterprises be equivalent to about 4% of GDP in the latter half of the 1980's, or approximately Rp. 2.4 - 2.6 trillion (at constant 1984 prices)/1. As a rough guideline, it is desirable that perhaps no more than 20-22% of this investment should be financed through bank borrowing, or approximately Rp. 500-550 billion annually, with the remainder coming from internal revenue generation, government equity contributions and long-term foreign borrowing on appropriate terms.

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/1 World Bank Report No. 5066-IND: "Indonesia: Policies and Prospects for Economic Growth and Transformation", April 26, 1984.

2.45 Table 2.7 shows the implications of such a strategy for the distribution of credit during the 1983-88 period. During 1984 there has been an increase in the level of public enterprise borrowing from the DMBs from Rp. 2.8 trillion to Rp. 4.5 trillion. This has been largely a result of the transfer of BULOG credits from Bank Indonesia direct credits to indirect credits financed by the DMBs and rediscounted with Bank Indonesia. After 1984, however, the level of credits to public enterprises is projected by World Bank staff to rise by about 5% per annum in real terms. This would imply an increase in credits to public enterprises of about Rp. 650-800 billion per annum, in nominal terms, annually. If public enterprises were limited to this level of borrowing, credit provided by the DMBs to the private sector could increase by about 8% annually in real terms during 1984-88, permitting a modest increase in the share of the private sector in total credit outstanding from 71% in 1984 to 75% by 1988. This projection underlines the need to limit public sector borrowing over the next few years in order to ensure that the private sector will have adequate access to DMB credits.

Table 2.7: DISTRIBUTION OF OUTSTANDING CREDIT, 1983-88  
(Rp. billion; end December)

	1983 Actual	1984 Actual	1985 -----	1986 Projected	1987 -----	1988 -----	Average Real Growth % p.a. 1984-88
Direct credits <u>/a</u>	2,356	870	900	800	700	600	-14.8
Credit to DMBs	4,365	6,938	7,573	8,154	8,282	8,527	-1.6
Net DMB credits	9,283	12,141	14,572	17,377	20,549	24,028	10.4
Total DMB credits	13,648	19,079	22,145	25,531	28,831	32,555	6.3
Public enterprises <u>/b</u>	2,884	4,543	5,051	5,682	6,414	7,246	5.0
Private sector	10,498	14,096	16,654	19,409	21,977	24,869	7.8
<u>Memo items (as % total credit):</u>							
Public enterprises (inc. direct)	18	23	22	22	22	22	...
Private sector	66	71	72	73	74	75	...
Total DMB credit <u>/c</u>	85	96	96	97	98	98	...

/a Excluding Central Government.

/b Including Bulog from 1984 onward.

/c The total of public enterprises and private sector credit does not add up to total DMB credit as the latter includes a small amount of credit to the Government.

Source: World Bank staff estimates and projections.

### Chapter 3

#### COST AND AVAILABILITY OF CREDIT

##### A. Introduction

3.1 Chapter 1 of the report reviewed the reforms undertaken by the authorities in the financial sector over the past two years against the background of the changing macroeconomic environment and their impact on deposit interest rates and deposit mobilization by the commercial banks. Chapter 3 discusses the impact of the financial sector reform on the cost of credit and lending operations of commercial banks and suggests steps to encourage term transformation by these banks.

3.2 As noted earlier, the recent reforms in the financial sector have brought about a number of important changes in the operations of commercial banks, particularly state banks, in Indonesia. These changes have been in many ways beneficial and desirable from the viewpoints of sound macroeconomic management and the further development of the financial system. Nevertheless they have significantly increased the real cost of funds and given rise to some concerns particularly with respect to the provision of longer term credit for investment through the financial system. The rate of increase of disbursements and approvals of new investment credits by commercial banks slowed down significantly in the year and half following the June 1983 reform; the development banks, which are also an important source of longer-term funds, are experiencing increasing difficulties in mobilizing relatively low-cost resources for funding their operations (Chapter 4); while the incipient capital market which had been making significant progress in 1982 and early 1983 has received a setback (Chapter 5). These developments have taken place at a time when the Government expects the private sector to make a major contribution towards accelerating aggregate investment in the economy over the 1984-1989 (Repelita IV Plan) period, and the financial sector to assist this process by mobilizing domestic resources and channeling these resources into increased investment.

3.3 The state banks' reluctance to extend term loans is related to their increased costs and risks of such lending, and apparently rigid, relatively low long-term lending rates. It is also consistent with prudent banking practices given the shortening of their deposit structure discussed earlier. Thus, it could be argued that (a) long-term lending rates will need to reflect market conditions, and (b) deposit mix of banks should be improved, in order to encourage commercial banks to provide more long term loans. At the same time, (c) intermediation costs of banks are relatively high in Indonesia. Reductions in these costs through increased efficiency of banks hold out possibilities over the longer term for lowering the costs of providing financial services to the economy. Against this background, Chapter 3 discusses the effects of the recent financial sector reform on the costs of lending, and policy requisites to encourage term transformation by commercial banks. Institutional improvements which are necessary to increase the operational efficiency of commercial banks and to enable the development banks to play a more effective role are discussed in Chapter 4 below.

## B. Costs of Bank Funds

3.4 As noted in Chapter 1 above, the June 1983 reform has substantially increased the state banks' interest rates on time and savings deposits, altered their deposit mix and reduced their access to Bank Indonesia's low-interest bearing refinance facilities.<sup>/1</sup> These changes, in turn, have had a significant impact on the costs of funds of state banks. Until the June reforms, the main sources of funds of the state banks had been zero or low-interest bearing demand deposits, public sector deposits and liquidity credits from Bank Indonesia.<sup>/2</sup> But now these banks have to offer 17-20% p.a. on time deposits, and rates averaging about 3.0% p.a. on their demand deposits (with the range being 0-7% p.a. according to the size of deposits and type of depositors). Moreover, unlike in the past, the bulk of their incremental deposits are now expected to be in the form of more expensive time and savings deposits (para 1.27 above). While the state banks will have access to BI's liquidity credits for financing the priority programs, their normal lending operations have to be financed primarily from the more expensive deposit gathering efforts.<sup>/3</sup>

3.5 Table 3.1 below quantifies the effects of these changes on the marginal costs of funds of state banks. Thus, incremental costs of deposit resources of state banks have averaged about 13-14% p.a. in 1984; since 10% of time deposits and 15% of demand deposits of banks will need to be kept with BI as reserve requirements (on which no interest is earned), the effective cost of incremental deposits to banks has been around 15% p.a. Given their intermediation costs (overheads, loan losses etc), the cost to banks of providing the loans from incremental deposits to non-priority purposes has been about 22-23% in 1984. As for priority programs, the cost to banks of lending depends on the share of such programs financed by banks out of their own funds and external sources, and the availability of low-interest liquidity credits from BI. On the basis of varying assumptions regarding the availability of liquidity credits from BI and the mix of state banks' deposits, the cost to banks of priority lending now ranges between about 14-16% p.a. (Table 3.1).

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<sup>/1</sup> These changes, as discussed in para 1.24 above, had little impact on private banks, since their interest rates were not regulated earlier.

<sup>/2</sup> In the past few years preceeding the June reforms these sources provided about three-quarters of the state banks' incremental resources.

<sup>/3</sup> Banks also accept foreign currency deposits (para 1.27 above); however, they prefer to match such deposits with corresponding foreign assets, for portfolio management reasons, rather than to lend such funds domestically; holding such assets abroad is also financially attractive, since banks could currently earn a spread of about 3% p.a. on assets held in Singapore plus any gains in local currency arising from the depreciation of the Rupiah vis-a-vis the US Dollar. If banks choose to lend such funds domestically in Rupiah, they would have to cover themselves against devaluation risks, which will raise the costs of such funds to the level of deposit rates on time deposits.

Table 3.1: INCREMENTAL COST OF STATE BANKS' FUNDS, 1984  
(In Rp. per Rp. 100 of deposits)

Sources of Funds	1984
<u>For Non-Priority Lending</u>	
Demand deposits /a	0.90
Time deposits /b	<u>12.60</u>
Average incremental cost of funds	<u>13.50</u>
Effective cost of loanable funds /c	<u>15.25</u>
<u>For Priority Programs, assuming:</u>	
75% of funds from BI & 25% from banks (own funds)	6.05
60% of funds from BI & 40% from banks (own funds)	7.90
50% from BI, 25% from banks and 25% external /d	<u>7.80</u>
<u>Memo Items</u>	
Intermediation costs	7-8
Costs of lending for "non-priority" programs	<u>22-23</u>
Costs of lending to "priority" programs	<u>14-16</u>

/a Assuming that demand deposits represent 30% of incremental deposits of banks in 1984 and that the average interest paid on demand deposits is 3% p.a.

/b Average deposit rate assumed to be 18% p.a.

/c 15% of demand deposits and 10% of time deposits are kept with BI as reserve requirements, on which no interest is earned. Thus, funds available for lending are 88.5% of deposits.

/d External funds at 10% p.a. in 1984.

Source: World Bank staff estimates.

### C. Nominal and Real Lending Rates

3.6 The state banks have endeavoured to adjust to this increase in their costs of funds by raising their nominal lending rates. Before the June 1983 reform, 93% of state banks' loans were made at rates of 13.5% p.a. or lower (Table 3.2); priority credits financed through liquidity credits from BI were mainly provided at 12% p.a. or less, while general lending for working capital as well as larger investment credits were made at 13.5% p.a. or higher rates. After June 1983, almost all the new lending of state banks has been at interest rates of 18% and above. Thus, loans made at interest rates below 13.5% p.a. had fallen to 50% of the state banks' portfolios /1 by December 1984 from 93% in March 1983; while loans made at 18% p.a. and above have increased from less than 4% to 44% of their portfolios over the same period. The lending rates of private banks have not been much affected, although there has been some upward movement in their rates.

/1 Excluding loans to BULOG which are being channeled through BRI after March 1984.

**Table 3.2: DISTRIBUTION OF OUTSTANDING CREDITS OF STATE AND PRIVATE BANKS,  
BY INTEREST RATE CHARGED, MARCH 1980-DECEMBER 1984  
(in percent p.a.; end March)**

	State Banks					Private Banks		
	13.5% & below	Over 13.5 Below 18%	18%	Over 18%	Weighted average rate	21% or less	Over 21%	Weighted average rate
1980	88.0/a	4.1/a	2.7/a	5.2/a	12.3/a	16.0	84.0	27.1
1981	89.9	3.2	2.2	4.7	12.6	17.4	82.6	26.4
1982	91.7	3.0	1.6	3.7	12.4	18.5	81.5	25.8
1983	93.4	2.9	1.2	2.5	12.6	22.1	77.9	24.9
1984	56.1	7.4	28.3	8.2	14.6	21.2	78.8	25.0
1984 December	50.1	5.8	21.2	22.9	15.5/b	17.0	83.0	26.5

/a December 1980.

/b Excluding loans to BULOG which are being channeled through BRI after March 1984.

Source: World Bank staff estimates.

3.7 Although the June reform, as noted in Chapter 1, has brought the deposit rates paid by the state and private banks into close alignment, lending rates of state banks on new loans have moved only some way towards those charged by private commercial banks. This is because the average cost of funds for the state banks is still lower than for the private banks. The state banks still have access to Bank Indonesia liquidity credits to finance priority credits, and demand deposits constitute a higher proportion of their deposit base. At the lower end of the range, interest rates on priority credits have been fixed at 12%. This is clearly less than the rate state and private banks are paying their customers on 3-12 month time deposits. At the upper end of the range, non priority borrowers of private banks are currently paying 24-28% for new loans. Thus there is a sharp degree of segmentation in the financial system between priority borrowers supported by Bank Indonesia liquidity credit programs and non priority borrowers of state and private banks who do not qualify for Bank Indonesia liquidity credits.

3.8 The rise in nominal lending rates has significantly increased real lending rates in the economy, since the rate of domestic inflation has continued to decelerate; the rate of growth of consumer prices, for example, has declined from 17% p.a. in 1980 and 12% p.a. in 1983 to 9% for 1984. As a result real lending rates are now at unprecedentedly high levels. While the borrowers under priority programs currently pay modest real interest rates of around 3% p.a., non-priority loans carry substantially higher rates: investment credits of state banks around 9% p.a. and working capital loans at 9-15% p.a. in real terms (Table 3.3). The real lending rates of private banks are even higher, ranging from 15-19% p.a.

**Table 3.3: REAL LENDING RATES OF STATE BANKS, 1980-84**  
(in percent per annum)

Program/purpose	December 1980	December 1982	May 1983	December 1984
<b>"Priority" Loans</b>				
BIMAS - rice & secondary crops	-5	2	..	3
Export & production of export goods	-5	-2.5	-4.5	<u>/a</u>
Production & import of fertilizer	-5	2	..	3
Credit to Co-ops	-5	2	..	3
Smallholder agriculture	-5	2	..	3
Permanent Working Capital (KMCP)	-5	2	..	3
Investment Credit (below Rp. 75 mn)	-6.5	0.5	-1.5	3
<b>Non-Priority Loans</b>				
Investment Credit (Rp. 75-200 mn)	-5	2	.. )	
Investment Credit (Over Rp. 200 mn)	-3.5	3.5	1.5 )	7.5-9
Working capital loans <u>/b</u>	-3.5	3.5	1.5	9-15
Other non-priority loans	1-4	8-11	6-9	9-15

/a Banks can charge differing rates, with current maximum of 3% p.a.

/b For manufacturing and service industries, domestic trade, sugar production and contractors on non-aid projects.

Source: Bank Indonesia.

3.9 The surge in new lending rates - outside of the priority credit programs - is of concern to the authorities, because the real burden of debt financing has increased significantly for a wide spectrum of borrowers. This factor, coupled with relatively sluggish domestic demand, has increased the financial and economic difficulties facing some businesses with possible adverse effects on bank portfolios. There is also apprehension that if these high real lending rates persist, there may not be many investments which could bear such real lending rates; and some investments which may be economically desirable may be postponed.

#### D. Supply of Term Loans

3.10 The state banks have been the main sources of long-term lending in Indonesia; and the recent reforms, apart from raising real lending rates, seem to have had some adverse effects on the capacity and willingness of state banks to undertake term lending. As noted in Chapter 1, until recently the Government used these banks as a vehicle for channeling cheap public funds into the economy to provide longer term loans for priority purposes and weaker economic groups; 75-100% of the long term loans (depending on purpose and type of borrower) by these banks were refinanced by BI at 3% p.a. As a result, medium and longer term loans comprised about 40% of the loan portfolios of these banks in 1984. These banks in turn accounted for nearly four-fifths of

long-term loans or 78% of the investment loans <sup>/1</sup> provided by the banking system. In contrast private banks prefer to keep their loan portfolios heavily weighted towards short-term working capital loans for reasons of profitability and risk aversion.

Table 3.4: MATURITY STRUCTURE AND SOURCES OF BANK CREDIT, DECEMBER 1984 <sup>/a</sup>  
(In percent)

	State Banks	Development Banks	Private Banks	Foreign Banks	All Banks
Less than 1 year	59.4	22.4	90.4	95.5	63.0
1-3 years	10.2	15.2	5.2	0.8	9.4
Over 3 years	30.4	62.4	4.4	3.7	27.6
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
<u>Memo Item</u>					
Share of each group in loans over 3 years	79.3	17.6	2.4	0.7	100.0

<sup>/a</sup> Excluding credits by Bank Indonesia.

Source: Bank Indonesia.

3.11 As Table 3.4 above indicates the availability of longer-term loans/investment loans has not been unduly low; the proportion of such loans in Indonesian banks' portfolios in 1984 was around 28%. Moreover, these statistics by type of credit and maturity, are somewhat misleading and underestimate the extent of bank financing of investment in Indonesia, since private banks who have close links with their borrowers generally roll-over short-term/working capital credits enabling their borrowers to finance investment activities. The real issue facing the authorities with regard to term lending, therefore, is not the adequacy of the past levels of term lending, but how to maintain the flow of long-term loans outside the liquidity credit-financed priority programs in line with investment demand in the future.

<sup>/i</sup> Investment loans are not identical with long-term loans of banks. Loans for investment purposes (as distinguished from those for consumption or working capital purposes), generally have maturities exceeding 3 years (i.e., are long term loans); but they also include loans granted for 1-3 years (i.e. medium term loans). On the other hand, long-term loans also include working capital loans granted for periods over 3 years, for example permanent working capital loans.

3.12 The rate of growth of state banks' lending in general slowed down sharply in the months following the June reforms <sup>/1</sup>; their lending to the private sector recovered somewhat in the first half of 1984, but the rate of growth of credit slowed down again in the second half of the year. The rate of increase of approvals and disbursements of investment credit (provided mainly by state banks) also slowed noticeably in the post-June 1983 period relative to the earlier years (Table 3.5).

3.13 It is difficult to establish with much certainty how much of the deceleration of state banks' lending, especially of investment credits in the latter half of 1983 and the first half of 1984, has been due to the effects of financial sector reform, or to general economic conditions and depressed demand for credit. It is likely that all these factors have contributed to it. Indeed, the growth of investment credits of state banks had begun to slow down during the downturn of the economy well before the June 1983 reform. Although the non-oil economy grew at a respectable rate of 4.3% p.a. (in 1981 prices) in 1984, available data suggest that investment activity still remains depressed.<sup>/2</sup> Weak consumer demand, the existence of substantial unused domestic production capacity in a number of sectors, restricted access to export markets (in such areas as plywood, textiles), as well as a range of uncertainties associated with domestic developments (tax reforms, etc.) have undoubtedly contributed to low investor confidence. It is also probably true that high real interest rates themselves have affected profitability and the willingness to invest. As discussed above, real interest rates on non-priority loans in Indonesia now range from 9% to 15% p.a. (Table 3.3). At these rates, many investments are likely to be relatively less attractive than the financial returns from short-term trading, real estate, or simply holding tax exempt financial assets (i.e. bank deposits).<sup>/3</sup>

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<sup>/1</sup> On the other hand, credit extended by private banks (mainly as working capital loans with short maturities) has accelerated sharply since June 1983 (Table 3.5). These and foreign banks have been much less affected by the recent reforms than state banks, and have been able to exploit the opportunities created by the abolition of credit ceilings by competing vigorously and responding quickly to customers' needs. They have also become net borrowers of surplus funds of state banks through the inter-bank money market; and their share of total bank credit has increased from 10% in March 1983 to 16% in December 1984. The dynamic growth of private banks and the development of the inter-bank money market are thus some of the noteworthy consequences of the financial sector reforms; these developments however will need to be watched carefully, in view of the need for private banks to gradually replace their substantial borrowings from the call money market last year by mobilising additional deposits.

<sup>/2</sup> For a fuller discussion see World Bank Report No. 5597-IND, "Indonesia - Policies for Growth and Employment", April 23, 1985.

<sup>/3</sup> At prevailing rates of income taxes, pre-tax returns of about 28-30% p.a. would have to be earned in order to break even with the returns from 1-year time deposits.

**Table 3.5: GROWTH OF BANK CREDIT, 1981-1984**  
(Change in percent per annum; end-December)

	1981	1982	1983	1984	<u>1983</u> June-Dec./ <u>a</u>	<u>1984</u> Jan-June	<u>1984</u> July-Dec.
<u>Total Bank Credit</u>	29.0	28.7	17.5	23.0	23.3	21.7	21.9
(To Public Sector)	(16.2)	(17.2)	(1.2)	(3.8)	(12.7)	(-9.2)	(17.5)
(To Private Sector)	(40.4)	(36.4)	(28.5)	(34.1)	(25.4)	(37.2)	(26.0)
State Banks / <u>b</u>	36.9	36.6	21.9	19.6	18.3	19.4	18.0
(To Public Sector)	(32.2)	(31.1)	(22.4)	(0.6)	(16.8)	(-8.9)	(10.5)
(To Private Sector)	(38.8)	(39.0)	(21.7)	(27.5)	(18.9)	(31.6)	(20.2)
Private Banks	47.3	43.5	57.3	61.6	69.5	60.7	47.8
Foreign Banks	32.4	21.5	29.4	21.3	53.9	41.1	1.3
<u>Investment Credit /<u>c</u></u>							
Disbursed and outstanding	37.4	42.7	33.9	22.0	26.7	21.2	20.5
New approvals	34.4	41.1	38.4	15.1	29.4	5.4	24.2

/a Change over end-May 1983, as the financial sector reform became effective on June 1, 1983.

/b Excluding credits to BULOG channelled through BRI from April 1984.

/c Excluding direct BI credits.

Source: Bank Indonesia.

3.14 It appears that the state banks themselves have also become more cautious with regard to investment/term lending, (as evident from the slowdown of approvals of new investment credits in Table 3.5). As discussed above, their costs of funds and lending risks have increased sharply (because borrowers with generally inadequate equity are now more vulnerable to debt-servicing problems at present high interest rates); while the maturity structure of their deposit liabilities has shortened considerably (para 1.31 above). In addition, banks themselves now have to fund longer-term loans outside the "priority" loans categories from their own resources, since "non-priority" loans are not eligible for BI's rediscount facilities since June 1983; these rediscount facilities, as noted earlier, were an important source of longer-term funds and underpinned 60% of long-term loans to the private sector (para 1.15). Given these circumstances, the increased caution of state banks with regard to term lending in the present situation accords with sound banking practices. In addition, due to informal restraints, present nominal lending rates for investment loans (banks, as discussed in para 1.20 above, are expected to lend at around 18% p.a.) are not sufficient to cover their increased costs and risks of term lending. At these rates it is clearly more attractive for banks to provide short-term loans and roll them over, and to hold surplus funds abroad, given the interest rates abroad,

uncertainties with regard to the future levels of oil prices and expectations of a depreciation of the Rupiah./1

3.15 The rise in real lending rates and these recent trends with regard to term lending/investment credits by banks, as noted above, have created apprehensions that investment activity in the economy could be adversely affected, and that this will make the task of sustaining the growth and transformation of the economy more difficult./2 However, banks themselves seem unwilling to increase their term loans (because of increased costs and risks) at present interest rates; but if long-term lending rates are raised further, private investment may be further discouraged. A major dilemma facing the authorities, therefore, is how to reconcile these conflicting pressures. The resolution of this dilemma is important because there is an underlying concern that if private investment does not pick-up sufficiently, it may be necessary to expand public investment correspondingly to ensure that the target growth rates of income and overall investment are met. And to the extent that the Government accumulates surpluses with the banking system, as discussed above, it may be increasingly difficult to withstand these pressures for extending credit to uneconomic projects or alternatively to once again expand subsidized credit schemes to promote investment.

3.16 There are clearly no easy answers to these issues. However, it should be pointed out that given Indonesia's macroeconomic outlook, prospects for oil and non-oil exports, and the need for careful management of the balance of payments and external debt situation over the next few years, the levels of aggregate investment which can be sustained with sound economic management are not very high - around 22% of GDP over the next five years, or about the same ratio to GDP as at present /2. Higher levels of investment, although desirable from many viewpoints, are not feasible, given the expected availability of foreign exchange or feasible levels of marginal domestic savings. In such a situation, liberal credit policies by themselves cannot push up investment rates, and as discussed in Chapter 2, will exacerbate inflationary pressures and lead to loss of reserves. Secondly, efforts to

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/1 For example, banks over the past year could have earned around 18-20% p.a. (SIBOR plus 9-10% depreciation of the Rupiah vis-a-vis the US dollar) at no risk simply by holding funds abroad; thus an 18% investment lending rate is not attractive at present.

/2 For a detailed discussion of Indonesia's macroeconomic prospects and development options, see World Bank Report No.5597-IND, "Indonesia: Policies for Growth and Employment", April 23, 1985.

encourage term lending by banks (in order to support increased investment) /1 should not be allowed to undermine the progress that has been achieved so far in the financial sector. A major challenge facing the authorities in this regard, as noted above, will be to resist introducing new programs with large subsidies to promote investment, which could create serious allocative problems, diversion and misuse of funds, and disincentives to banks for mobilizing domestic financial resources - all familiar problems before the June 1983 reforms.

3.17 In this context, the rest of this chapter discusses the prospects for real interest rates in Indonesia over the next few years, and focuses on steps that can be taken to improve the supply of longer-term funds for investment through banks.

#### E. Prospects for Real Interest Rates and Investment Demand

3.18 The prospects for real lending rates, as discussed in Chapter 2, depend on domestic deposit rates and intermediation costs of banks. The evolution of domestic deposit rates, in turn, depends on several important factors: firstly, given Indonesia's open capital account, domestic deposit interest rates are considerably dependent on developments in the international capital markets. Secondly, oil price movements have a crucial bearing on the balance of payments and the formation of expectations on exchange rate movements in Indonesia. Thirdly, the Government can to some extent influence expectations regarding future exchange rate movements and help bring down the present deposit interest rate differentials between Indonesia and financial markets abroad through prudent monetary and fiscal policies, provided there is stability in the oil markets. Given domestic deposit rates, the outlook for domestic lending rates will also depend on the behavior of intermediation costs of banks.

3.19 International interest rates have already declined significantly over the past six months. However, this decline has not had any significant impact on domestic deposit rates, even though the rate of domestic inflation in

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/1 It can be argued that more term lending is also desirable from other view points: Although banks now provide and frequently roll-over considerable short-term credits, this constitutes a relatively costly and inefficient form of financing investment. Firstly, the cost of credit to borrowers remains unnecessarily high; borrowers also incur additional transactions costs in rolling-over such credits; uncertainties and difficulties in rolling over short-term credits could disrupt time schedules of investors, create liquidity problems and unnecessary risks for investors, and deter investment. This problem is likely to be particularly serious for smaller, relatively less established, borrowers. Finally, the process of term lending itself could fulfil an important developmental need in the Indonesian context. Banks, in providing term lending, will need to pay greater attention to the quality and viability of projects they finance and this process would help to improve project selection in general and the quality of banks' portfolios, as well as facilitating institutional development in the financial sector.

Indonesia has abated noticeably in the past year. This unusual situation, characterized by high nominal and real deposit and lending rates, largely reflects increased uncertainties with regard to oil price movements over which Indonesia has no control. These uncertainties with regard to oil price movements could limit the extent to which the Government could influence the formation of expectations regarding exchange rate risks through policy actions. Moreover, given the uncertain prospects for oil prices over the next few years, it seems unlikely that domestic real deposit and lending rates in Indonesia would come down to any significant extent over the medium term. On the other hand, there is scope to bring about some reduction in the presently high intermediation costs of Indonesian banks through domestic actions. To the extent that high intermediation costs of state banks (associated with their organizational structure, pattern of historical development and poor loan quality) can be reduced through measures discussed in Chapter 4 below (for example through programs to improve recoveries, write-offs of bad loans, and organizational improvements to reduce overall intermediation costs), real lending rates can be reduced by 3-4 percentage points over the longer term. It is therefore important that appropriate actions are taken in this regard.

3.20 On the other hand, if real interest rates remain high (given the uncertainties noted above), they are likely to have potentially adverse effects on future investment demand and overall level of economic activity in Indonesia. This report does not address the issue of future investment demand. Nevertheless, it is an important issue which needs to be monitored closely, in view of the need for adequate levels of investment consistent with the country's development priorities and objectives.

#### F. Measures to Facilitate Term Lending

3.21 The elements of a strategy to facilitate term lending through the Indonesian financial sector over the next few years should constitute the following: The banking system will continue to be the major source of investment finance in Indonesia over the foreseeable future. In order to facilitate term lending by banks some major problem areas will need to be addressed particularly with regard to (a) intermediation costs, (b) term lending rates, and (c) deposit mix of banks. Until such time as commercial banks begin to assume full responsibility for term lending, however, development banks, (who, at present, are also important sources of term lending) will need to continue to play an important role in providing term loans; also, these institutions themselves will need to be rationalized and strengthened (Chapter 4). Finally, efforts are needed to diversify financing options available to investors by encouraging the development of the capital market (Chapter 5).

3.22 Lending Rates. It is important to recognize that banks could be induced to term transform only if they find it attractive, i.e. at or near market rates. As noted earlier, the current long-term lending rates of banks (18% p.a.) are not high enough to cover the increased costs and risks of such lending. These rates should be allowed to rise, and this will raise the costs to borrowers in the short term. However, the capping of interest payments and extending maturities (see below) could alleviate the difficulties of borrowers.

3.23 In the interim, long-term lending rates will need to rise, and this may create serious problems for borrowers. For example, if long-term lending rates are set at the level of short-term rates plus a margin, these can exceed the capacity to repay and some desirable investments which would be undertaken at more realistic interest rates could be postponed. To the extent that short-term interest rates decline in the future, however, a system of long-term lending at variable rates would help to overcome these problems. Such an approach will encourage financial intermediaries to term transform by reducing their interest rate risks; it will also automatically reduce long-term lending rates as short-term rates decline. On the other hand, variable rates for long-term lending shift the interest rate risk to the borrower. Sharp increases in, or high, interest rates raise debt service payments in the early years of a project and distort the correspondence between the cash flow of the project and loan repayments. Such increases in debt service obligations can create serious cash flow problems for investments with long gestation periods./1

3.24 This problem, however, can be alleviated through the capitalization of interest payments. Variations of this approach have been used in Mexico, U.K. and the U.S. These schemes essentially split the lending rate into two parts - a cash payment rate and a capitalization (accrual) rate. Actual interest rate paid is equal to the cash payment rate multiplied by the principal, following conventional practice. The capitalization rate - the excess of the lending rate over the cash payment rate - is used to adjust the principal. The principal can then be amortized as desired. For example, the payments of principal during the latter part of the loan repayment period could be increased without extending the life of the loan; alternatively, the repayment period itself can be extended, thereby effectively putting a cap on periodic debt service payments. Such a system would help to deal effectively with front loading, as well as peaking of debt service, at any point of time in the loan repayment cycle.

3.25 In the present context, a desirable solution would be to permit capping of cash payments. A borrower and lender could agree to cap cash payments, for example, at 15% p.a.; the excess of interest plus whatever margin charged could then be added to the principal (capitalized) and subject to interest payment and amortization in subsequent years. The principal of the loan could be amortized in accordance with the usual Indonesian practice /2, or the term of the loan can be extended by prior agreement between borrower and lender. In sum, the prime rate plus whatever margin is charged, would be the interest rate; 15% would be the cash payment rate; and the difference would be the capitalization rate.

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/1 Such "front loading" of debt service is not necessarily a consequence of variable interest rates. Conventional repayment plans which do not try to match repayment streams with the cash flow of a project could have this effect. In such cases variable rates by raising cost of debt servicing as interest rates rise can accentuate this problem.

/2 The usual Indonesian practice on long-term loans involves matching the amortization schedule with the cash flow of the project - usually an increasing rate of amortization.

3.26 Some of the Indonesian state banks are already moving towards variable rate lending on long-term loans made with their own resources; rates on such loans are being adjusted at quarterly to annual intervals. However, the amount of such lending still remains quite limited. The slowly evolving system of variable rate lending also suffers from a serious defect from borrowers' standpoint: each bank's variable rate is based on its own cost of funds, rather than on a system-wide index (such as a prime rate), or on the system's average cost of funds. The borrower is thus subject to the variations in an individual bank's costs of resource mobilization and administration; and since these costs are not usually made public, he does not know whether the adjustment in his rates is reasonable or not.

3.27 A significant improvement could be made in the current system if either (a) banks announce their prime rate (as in the U.S.) or (b) Bank of Indonesia performs a purely informational function, calculating and publishing a systemwide average <sup>/1</sup> cost of term deposits weekly, as is done in the Philippines (Manila Reference Rate) and in Mexico (Average Cost of Loanable Funds). This would enable individual banks to quote loan rates which would vary over the life of the loan according to variations in the index, plus some fixed margin, while providing more information for the borrower than at present. Such a scheme would considerably improve the cash flow for the borrower and mitigate the risks and disincentives to the lender.

3.28 There are other more complicated approaches to capitalization of interest, for example setting the cash payment rate at the inflation rate. However, unless lending rates remain very high, it is advisable to avoid the complications involved in frequently setting and resetting a cash payment rate. It is also prudent to proceed cautiously in implementing a capitalization scheme and leave lenders and borrowers to decide the pace of its evolution, rather than mandating capitalization universally. Firstly, the financial system will need time to adjust to variable rate lending and the use of a deposit index. Secondly, the universal imposition of capitalization could over time result in increased vulnerability of the financial system to crisis. This is because, with capitalization of interest, (and in contrast to a system of full payment of interest due), the lending institutions may not receive signals of impending problems when the borrower is able to cover the

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<sup>/1</sup> Such an index should be designed to reduce the interest rate risks involved in term transformation — the objective of variable rate lending — by adequately reflecting the incremental costs of new deposit resources. Thus the index should weight the interest rates on new or renewed deposits heavily, or, more simply, include only the rates on short term instruments, since these rates, by their nature, reflect the current market situation. Using such an index, financial intermediaries can add on a suitable margin to cover their risks on long-term lending commitments based on short term, potentially volatile deposits. They can also seek longer term deposits at either fixed or variable rates if these seem profitable. In contrast, a lending index which is based on the average rate on all existing interest-bearing deposits will lag behind deposit costs and correspondingly subject the intermediaries to pressures when interest rates are rising, although these pressures will be less than those with a completely fixed lending rate.

non-capitalized portion of interest, but not the full debt service owed. This is all the more reason for improving the capacity for credit appraisal and evaluation of loan risks, especially of state banks (see paras 4.44-4.45 below).

3.29 Arrangements such as those above will help to increase the flow of long term funds through the banking system. This process could be facilitated further by encouraging the growth of the capital market (Chapter 5) and other arrangements to increase the availability of venture capital (Chapter 4). As noted earlier, the lack of equity capital, and consequent increases in debt-service liabilities of borrowers and lending risks of banks as interest rates rise are major deterrents to term lending by banks. It is therefore important to address the term transformation problem from both sides - through measures designed to match debt service obligations of borrowers with their repayment capacity as above, as well as by reducing lenders' exposure through arrangements to increase equity financing (see Chapter 5).

3.30 Several steps could also be taken to improve the deposit mix of banks. As discussed below (para 4.28), the efforts being made by state banks to expand their base of low cost demand deposits are still inadequate; there are opportunities for tapping such deposits by improving banking facilities in urban residential and rural areas, by increasing the range of financial instruments available, for example by introducing savings accounts with increased withdrawal facilities, and by promoting longer-term CDs; (the latter, however, will require greater differentiation of interest rates than is presently paid on 12 and 24 month deposits and the removal of discriminatory tax treatment of long-term deposits as compared to shorter-term bank deposits)./1 Such efforts to mobilize savings from smaller urban and rural savers would not only help to increase the flow of savings into the financial system and over time to reduce the average costs of funds to banks, but would also help stabilize the banks' base of rupiah deposits by tapping those depositors who are relatively less sensitive to interest rate movements abroad and expectations of exchange rate changes (para 4.66).

3.31 Another way of reducing the costs of funds of banks would be to lower the banks' costs of holding mandatory reserves with BI. As noted above, at present, bank reserves held with BI earn no interest; this in effect adds about 1-1.5% p.a. to the effective cost of funds of banks. BI could lower these costs by paying interest to banks (for example close to the average costs of deposits of banks) on these reserves./2

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/1 As with bonds, interest earnings from bank deposits with maturities exceeding two years are taxable in the hands of the recipients, while interest earnings from bank deposits of shorter maturities are not taxable (para 5.9 below).

/2 Until recently BI paid interest to banks on excess reserves maintained with BI. However, these excess reserves amounted to only a small proportion of the required/statutory reserves. Thus, if BI were to pay market rates of interest only on excess reserves (and not on statutory reserves), the effect on the banks' cost of funds would be negligible.

3.32 As noted earlier, the banks' deposit liabilities are concentrated in demand deposits and savings and time deposits of relatively short maturities. As of June 1984, only 20% of state banks' deposit liabilities were in savings and time deposits with maturities over one year. To some extent this short maturity structure inhibits their ability to undertake long-term lending outside of the priority credit programs. There is also a need, if banks are encouraged to increase term lending, to protect them against financial crises caused by mismatches between their loan portfolios and deposit structure, and resulting interest rate risks.

3.33 To the extent that the Government's net deposits with Bank Indonesia increase, these can provide a means for improving the maturity structure of banks' deposits in order to encourage them to undertake more term lending, while at the same time increasing Bank Indonesia's capacity to manage domestic liquidity and credit expansion more smoothly. One of the challenges which BI faces in the medium term, as noted in para 2.18 above, is to regulate the money base in an orderly fashion. The special credit programs, given their cyclical nature and implementation schedules, are not a suitable vehicle for this purpose (para 2.18). The major instruments available to BI (open market operations, SBIs, variations in reserve requirements, etc) could, on occasion, be inadequate or inappropriate for the purpose of injecting liquidity into the banking system (para 2.19). As noted earlier, the introduction of MMS provide BI some flexibility now to influence domestic liquidity conditions. This flexibility could be further enhanced and banks' deposit mix further improved at the same time, if BI, for example, were to develop an alternative instrument by placing surplus government funds deposited with it as CDs with commercial banks as discussed in para 2.20 above. To the extent that such CDs include relatively long maturities, such an arrangement would help to improve the maturity structure of banks, (within the limits set by money base management considerations for the issuance of CDs), and encourage them to undertake longer-term lending.

3.34 The reduction or elimination of some of the existing restrictions on bank lending is desirable, although it is doubtful whether in the short run this will increase term lending by private and foreign banks. Among the most notable restrictions are those which prohibit private banks to lend longer than 5 years, and restrict foreign banks to the provision of short-term loans to foreign companies and to joint ventures operating in Jakarta only. State banks are also required to provide term loans only to indigenous borrowers. These restrictions, imposed over a long period of time, have been motivated by various considerations /1, some of which may be less binding now than before, or need to be reviewed in the light of the Government's changing policy goals. The objectives underlying some of the restrictions could also be achieved in other ways. For example it is possible to ensure the solvency of private banks by limiting their exposure to and tie-ups with particular groups

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/1 For example, the Government through these restrictions has endeavoured to achieve broader socio-economic and political goals of encouraging Indonesianization of economic activities, reducing monopoly power by particular economic groups, provide more equitable access to development opportunities to indigenous entrepreneurs and ensure solvency of private banks by limiting their commitments and exposure to a few borrowers.

of borrowers through improved banking supervision, without rigid rules which require prior BI approval for term lending. Similarly, foreign banks could be encouraged to lend outside Jakarta in partnership with state banks. The relaxation of restrictions on term lending by state banks is more problematic; while this is a complex issue which needs careful review in the light of the Government's broader social, political and economic objectives, it is difficult to see how the Government's targets for private investment could be achieved without some relaxation of these restrictions. With this objective in view, Bank Indonesia recently changed the definition of the target groups which are eligible for term lending by the state banks from "indigenous borrowers" to "weaker economic groups"; but this redefinition needs to be spelt out more clearly in order to remove the ambiguities which the state banks are still facing.

## Chapter 4

### INSTITUTIONAL DEVELOPMENT OF THE BANKING SYSTEM

4.1 Chapter 3 of the report reviewed the impact of the financial sector reform on the cost and availability of bank credit, and discussed mechanisms to improve the deposit mix of banks and to provide incentives to banks in order to facilitate term lending. That chapter also noted that it is necessary to keep term lending rates at levels which are affordable by investors; and that over the longer term reductions in intermediation costs of banks through institutional improvements would provide an important means of containing the cost of term credit. In addition to commercial banks, the specialized development banks are another important source of term credit. However, these development banks are facing serious operational and financial constraints. The present chapter discusses the institutional improvements which are necessary to (a) strengthen and improve the development banks, and (b) increase the efficiency of state banks in order to make them more effective in providing term finance.

#### A. Strengthening and Improving the Development Banks

4.2 The development banks in Indonesia are facing serious operational problems including funding constraints and the deterioration of the quality of their portfolios. There is therefore a need to develop an action program to deal with these problems. What direction a reform program in this sector should take, however, is an open question. The authorities, as noted above, are encouraging other financial institutions to be self-reliant in terms of resource generation and to be operationally independent. Perhaps the most important issue with regard to development banks, against this background, is whether they should continue to be specialized institutions requiring government support or whether they should be encouraged to be general purpose banks. The first part of this chapter reviews these issues in greater detail and outlines a strategy for strengthening and improving development banking institutions.

#### The Structure and Present Role of Development Banks

4.3 At present, there are 31 development banks <sup>/1</sup> in Indonesia: (a) four specialized development banks (Bank Pembangunan Indonesia - BAPINDO, P.T. Private Development Finance Company of Indonesia - PDFCI, P.T. Usaha Pembiayaan Pembangunan Indonesia - UPPINDO and P.T. Bahana Pembinaan Usaha - BAHANA) which largely concentrate on traditional development banking functions of term financing and project promotion, and have nationwide operational jurisdiction; and (b) 27 Regional Development Banks (RDBs) which by law are

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/1 According to the Government's official definition, a development bank is an institution which raises its resources from deposits and engages predominantly in project lending. By this definition only BAPINDO and RDBs qualify as development banks. UPPINDO, PDFCI and BAHANA are officially categorized as development type non-bank financial institutions. For the purpose of this chapter, development banks are defined more broadly to include those institutions whose major function is to provide term lending.

restricted to their respective provinces and largely operate as provincial commercial banks, performing very limited development banking functions. The Government has played a major role in promoting all these development banks and has direct or indirect ownership in almost all of them./1

4.4 The largest of these institutions is BAPINDO, with assets of Rp. 856 billion in 1983, equal to about 47% of the total assets of the development banking sector. Other institutions of any significant size are PDFCI with assets of Rp. 105 billion in 1983 and Jakarta Raya RDB, the largest RDB, with total assets of Rp. 133 billion in 1983. Many of the other development banking institutions (including BAHANA) are quite small, and this, as discussed in paras 4.18 below, is a major source of weakness among the development banks.

Table 4.1: TOTAL ASSETS OF DEVELOPMENT BANKS, DECEMBER 1983

Institution	Total Assets	
	Rp. billion	in %
BAPINDO	856	47.3
PDFCI	105	5.8
UPPINDO	57	3.1
BAHANA	16	0.9
RDBs	777	42.9
<u>Total</u>	<u>1,811</u>	<u>100.0</u>

Source: Bank Indonesia; development banks.

4.5 The role of development banks in the financial sector has increased steadily in recent years (Table 4.2). The share of development banks in total banking sector assets rose from 7.5% in 1980 to 8.6% in 1983; and their share of total bank credit increased from 7.4% to 9.6% over the same period. The emergence of development banks as an important source of investment credit has been even more striking; investment credit by development banks increased at an annual rate of 51% between 1980 and 1983 as compared with 36% p.a. by all banks; and their share of investment credit extended by the banking system rose from 14% to 19% over the same period. Of equal importance, investment credits provided by development banks have been generally of longer maturities - 5-10 years on average as compared with maturities of 3-5 years by commercial banks.

/1 For example, the Government owns 100% of the share capital of BAPINDO, BAHANA and RDBs, and 75% of UPPINDO and 22% of PDFCI.

**Table 4.2: DEVELOPMENT BANKS' SHARE IN TOTAL BANKING SECTOR, 1980-83 /a**  
(Rp. billion)

	1980	1981	1982	1983	Average nominal growth per annum
<b>Total Assets</b>					
All banks - amount	10,187	13,234	16,047	20,994	27.3
Development banks - amount	766	1,018	1,440	1,796	32.8
Share of Dev. banks - percent	7.5	7.7	9.0	8.6	
<b>Total Credit Outstanding</b>					
All banks - amount	5,459	7,553	10,306	13,017	33.6
Development banks - amount	402	654	978	1,245	45.7
Share of Dev. banks - percent	7.4	8.7	9.5	9.6	
<b>Total Investment Credit Out- standing</b>					
All banks - amount	1,506	2,134	2,946	3,815	36.1
Development banks - amount	208	324	537	713	50.8
Share of Dev. banks - percent	13.8	15.2	18.2	18.8	

/a Consists of deposit money banks plus PDFCI, UPPINDO and BAHANA.

Source: Bank Indonesia; development banks.

4.6 The development banks also provide an alternative source of funding to commercial banks for many borrowers. Indeed, BAPINDO has emerged as the country's single most important source of long-term finance for project financing. BAPINDO provides assistance to projects of all sizes - small, medium and large; and is not different from the five state banks in this regard. On the other hand, PDFCI lends mainly to medium sized projects ranging from Rp. 350 million to Rp. 7 billion in size; while UPPINDO lends primarily to projects with a size range above the KIK/KMKP program and below the lower limits of BAPINDO and PDFCI - i.e. between Rp. 75 million and Rp. 350 million. BAPINDO, UPPINDO and PDFCI have also acquired a degree of project appraisal and financing expertise and, in addition perform invaluable technical assistance and promotional functions for projects. BAPPINDO and UPPINDO are also actively engaged in assisting the smaller RDBs develop their institutional capabilities through technical assistance to these banks and joint financing of projects. Finally, the RDBs provide for credit needs (mostly working capital) of local small enterprises and projects of Provincial Governments, although as noted earlier, the development role of these institutions is as yet relatively small.

4.7 While these achievements are noteworthy, development banks have been less successful in other respects. For example, partly as a result of its rapid recent growth BAPINDO now faces a number of institutional weaknesses (paras 4.11-4.15 below). Moreover, all these institutions remain dependent on the Government or Bank Indonesia for resources. The second largest institution - PDFCI - has developed into a reasonably effective development bank with a reputation for professionalism; but its contribution to industrial investment remains marginal, partly due to its relatively small size. (Since its inception in 1973 PDFCI has financed 120 projects amounting to only Rp. 69 billion). PDFCI has also not been able to introduce more innovative forms of financing <sup>/1</sup> and promotional work; it has restricted its operations to traditional instruments - mainly direct loans and small amounts of equity investments. Similarly even though BAHANA is the only specialized venture capital company in Indonesia, its scale of operations has remained miniscule; up to end 1983, BAHANA provided Rp. 4.4 billion to 41 projects, and only 15% of this amount was in the form of equity. BAHANA's growth has been affected by lack of resources as well as heavy concentration on small scale projects, which has resulted in a very limited demand for BAHANA's assistance, since the sponsors of smaller projects are generally reticent about sharing management control.

#### Major Issues Concerning Development Banks

4.8 The Indonesian development banks are constrained by a number of structural, operational and financial issues. Most of these issues have persisted for a long time, but they have intensified in recent years for two reasons: First, in the case of BAPINDO, the rapid growth in lending in the 1970s and especially in the early 1980s has overstretched its capacity. Second, the financial sector reforms of June 1983 have radically changed the environment in which development banking institutions operate. In this new environment, the future growth and role of development banks will largely depend on the resolution of the following issues: (a) constraints on resource mobilization; (b) portfolio problems; (c) shortage of skilled manpower; (d) operational constraints, and (e) suboptimal scale of operations (in the case of many of the smaller development banks). These issues are addressed below.

4.9 Resource Constraints. All of the development banks in Indonesia rely heavily on the Government and Bank Indonesia for the bulk of their resources. The inability of development banks to mobilize resources from the market in the past, however, should not be regarded as a failure on their part. Until recently, resource mobilization has not been among the objectives set for these banks; indeed, only BAPINDO, among the nationwide development banking institutions, is authorized to mobilize deposits. Second, as in the case of state banks, the Government's financial and credit policies discouraged resource mobilization by development banks. For example, until the June 1983

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<sup>/1</sup> The major objectives of PDFCI at the time of its establishment were: (a) to transfer resources to private enterprises in order to accelerate the country's development; (b) to improve the quality of resource allocation by applying project evaluation techniques and providing industry with a wide range of technical, promotional and financial assistance, and (c) to mobilize, over time new sources of funds from the international capital markets.

reforms the development banks - BAPINDO and BAHANA in particular - were expected to lend only to weaker economic groups /1 at fixed low interest rates. (The state banks were also subject to this constraint in their investment lending, but they could charge higher interest rates at least on their working capital loans). Given these low interest rates, it was not financially feasible for development banks to mobilize deposits or raise funds from the market. Nor was there much incentive to do so, since the Government provided the needed resources at subsidized rates in various forms: (a) share capital contributions; (b) direct loans; (c) liquidity credits from Bank Indonesia; and (d) guarantees against loans made by the World Bank and Asian Development Bank (Table 4.3). The development banks have had some limited success in raising short-term funds from the market through deposits and money market borrowings; but these constitute only a small fraction of their total needs, and are unsuited for financing their long-term lending. These financing arrangements have also acted as disincentives to improving the operational efficiency of these banks and contributed to their portfolio problems (paras 4.11-4.15).

4.10 The June 1983 reforms have had far-reaching implications for development banks, in regard to their financing arrangements and objectives. The Government now expects development banks to become more self-reliant and mobilize their resource requirements from the market. However, the development banks cannot exclusively rely on mobilizing funds from the market, play their traditional role and still remain financially viable. First, development banks will need to pay going market rates (around 20% p.a. for 2 year deposits) in order to attract deposits; indeed the smaller development banks may have to pay higher rates because of the depositors' risk perceptions, given their small size and specialized nature. Second, given the present preferential treatment of bank deposits vis-a-vis bond issues (Chapter 5), development banks will need to pay around 30% p.a. for bond issues to make them attractive to potential private holders. Thus, a blend of funds through bond issues, bank deposits and direct borrowings (for example from pension funds at market rates), is likely to average around 20-22% (Table 4.4). Allowing for administrative costs, overheads and risks of about 6%, the lending rate of development banks would be around 26-28% p.a. This is clearly not an affordable level to many investors. In contrast, present lending rates of BAPINDO are around 18% p.a. Thus, unless development banks have continued access to lower cost government funds as discussed in para 4.32 below, and some flexibility in adjusting their lending rates to match their risks and collateral (para 4.33), they are likely to continue to experience severe funding problems.

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/1 PDFCI and UPPINDO are not handicapped by these restrictions on their clientele; however, since they have confined the bulk of their lending to economically weaker groups, they have effectively experienced the same difficulties stemming from low fixed lending rates as BAPINDO and BAHANA.

Table 4.3: SOURCES OF FUNDS OF DEVELOPMENT BANKS, DECEMBER 1983  
(Rp. billion)

	BAPINDO		PDFCI		UPPINDO		BAHANA		RDBs		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
<u>Obtained from/with</u>												
<u>Government Support</u>	<u>698.1</u>	<u>81.5</u>	<u>54.4</u>	<u>51.9</u>	<u>41.4</u>	<u>72.5</u>	<u>14.5</u>	<u>92.4</u>	<u>559.5</u>	<u>72.0</u>	<u>1,367.9</u>	<u>75.5</u>
Paid in capital	90.0	10.5	1.5	1.4	6.0	10.5	6.0	38.2	42.7	6.3	152.2	8.4
Government loans/ deposits	118.4	13.8	5.9	5.6	-	-	-	-	393.8	51.3	523.1	28.9
Bank Indonesia loans	406.0	47.4	41.0	39.2	35.4	62.0	8.5	54.2	112.0	14.4	602.9	33.3
Government guaranteed loans	83.7	9.8	6.0	5.7	-	-	-	-	-	-	89.7	4.9
<u>Self Mobilized</u>	<u>158.1</u>	<u>18.5</u>	<u>50.4</u>	<u>48.1</u>	<u>15.7</u>	<u>27.5</u>	<u>1.2</u>	<u>7.6</u>	<u>217.7</u>	<u>28.0</u>	<u>443.1</u>	<u>24.5</u>
Paid in capital	-	-	3.0	2.8	2.0	3.5	-	-	-	-	5.0	0.3
Retained earnings	17.8	2.1	2.4	2.3	1.8	3.1	0.5	3.2	43.3	6.2	70.8	3.9
Money market borrowings	-	-	42.3	40.4	7.4	13.0	-	-	23.7	3.7	78.4	4.3
Deposits	73.6	8.6	-	-	-	-	-	-	93.9	12.7	172.5	9.6
Other funds	66.7	7.8	2.7	2.6	4.5	7.9	0.7	4.4	41.8	5.4	116.4	6.4
<u>Total</u>	<u>856.2</u>	<u>100.0</u>	<u>104.8</u>	<u>100.0</u>	<u>57.1</u>	<u>100.0</u>	<u>15.7</u>	<u>100.0</u>	<u>777.2</u>	<u>100.0</u>	<u>1,811.0</u>	<u>100.0</u>

Source: Bank Indonesia; development banks.

Table 4.4: COSTS OF MARKET BORROWING AND IMPACT ON DEVELOPMENT BANKS

	Alternative I	Alternative II
Bank deposits/Other <u>/a</u> (80% of funds at 20% p.a.)	16.0	16.0
Bond issues (20% of funds)	6.15 <u>/b</u>	4.0 <u>/c</u>
Costs of borrowing	<u>22.15</u> <u>/d</u>	<u>20.0</u> <u>/d</u>
Spread required	6.0	6.0
Costs of lending	<u>28.15</u>	<u>26.00</u>
Present lending rate	<u>18.0</u>	<u>18.0</u>
Shortfall	<u>-10.15</u>	<u>-8.0</u>

/a Direct borrowing from insurance companies etc.

/b At 30.8% p.a. assuming that bond incomes are taxable at 35% tax rate at the hands of recipients.

/c Assuming same tax treatment of bonds as bank deposits.

/d Assuming a mix of 80% bank deposits/insurance funds and 20% bonds.

Source: World Bank staff estimates.

4.11 Portfolio Problems. Together with resource constraints, a progressive deterioration of portfolio quality is among the principal problems development banks are now facing. At present all three major development banks are experiencing portfolio problems (Table 4.5); recent evidence suggests that this situation is deteriorating further.

4.12 The actual incidence of the arrears of development banks is much more severe than revealed by the arrears ratio; when the percentage of the portfolio actually rescheduled/written off is added to the arrears ratio the situation is indeed unhealthy. Data for BAPINDO in fact suggest that by December 1984 the arrears ratio (principal and interest payments which are in arrears by over three months as a percent of the portfolio) rose to 6.9%, and that the proportion of the loan portfolio affected by such arrears rose to 31%. All the development banks also have a very low loan collection ratios, a strong indication of deterioration in portfolio quality. For example, BAPINDO's collection ratios in 1982 and 1983 were 76% and 69%, while PDFCI's were 71% and 64% respectively. BAPINDO's collection ratio deteriorated further to 58% in 1984.

**Table 4.5: DEVELOPMENT BANKS: INDICATORS OF PORTFOLIO QUALITY, 1980-83**

	1980	1981	1982	1983
<b>BAPINDO</b>				
Arrears ratio <u>/a</u>	3.2	1.5	2.1	3.1
Rescheduling/write-off ratio <u>/b</u>	5.7	4.3	5.4	7.9
Portfolio affected <u>/c</u>	4.4	5.3	9.7	13.9
<b>PDFCI <u>/d</u></b>				
Arrears ratio <u>/a</u>	12.0	15.4	9.6	10.4
Rescheduling/write-off ratio <u>/b</u>	10.6	3.8	10.7	17.2
Portfolio affected <u>/c</u>	33.8	23.6	33.1	25.2
<b>UPPINDO</b>				
Arrears ratio <u>/a</u>	13.8	15.6	8.7	6.4
Rescheduling/write-off ratio <u>/b</u>	10.0	6.8	15.5	13.5
Portfolio affected <u>/c</u>	34.3	34.8	29.6	14.5

- /a Arrears ratio = arrears (over three months) of principal and interests as % of total loan portfolio.
- /b Rescheduling/write-off ratio = Amounts rescheduled and written off during the year as % of total portfolio outstanding.
- /c Portfolio affected = total outstanding amount of loans in arrears as % of total portfolio outstanding.
- /d In addition to the arrears on its term loan portfolio, PDFCI has a major delinquency problem (16.5%) on its short-term portfolio of money market placements which represents about 56% of its total assets.

Source: Development banks.

4.13 Several factors have contributed to the widespread portfolio problems of the development banks. Among these are general factors which have affected operations of all lending institutions alike: the prolonged recession in the manufacturing sector; high interest rates since 1983 which have affected debt servicing capacity of borrowers; and the rupiah devaluation which distorted the cost/revenue structure of import substitution projects (since cost increases have not been fully matched by increases in output prices) which constitute a major proportion of the portfolio of development banks. Some of BAPINDO's clients were also affected by changes in the Government's policies concerning specific subsectors (such as a ban on the export of logs which affected logging and maritime loans); in addition, BAPINDO's portfolio has been affected by the problems of some state-owned projects (for example in the pulp and paper, cement and tire-making sectors) which BAPINDO had been required to finance and over whose activities BAPINDO has virtually no influence.

4.14 However, the most significant factors responsible for the deterioration of portfolio quality have been internal to development banks: poor management of projects, and institutional weaknesses. The development

banks lend almost exclusively to economically weaker groups and entrepreneurs, who generally have limited project experience and knowhow and financial resources; the development banks also lend for longer periods and carry a higher proportion of longer-term loans in their loan portfolios as compared to commercial banks. Consequently their risk exposure is generally higher than those of state banks.<sup>/1</sup> While this in turn calls for careful appraisal and supervision of loans, the quality of appraisal and follow up has been deficient. The development banks have generally endeavored to expand their operations far too rapidly (e.g. BAPINDO) without commensurate increases in their staff strength. This has resulted in inadequate appraisal of projects and financing of questionable projects which have subsequently run into operational, marketing and financial problems. In addition, staff resources assigned to supervision work has been inadequate both in terms of the volume of work and project specific problem solving capabilities. These institutional problems are to some extent due to a general shortage of skilled manpower in Indonesia; but a deliberate policy of the development banks to keep down staff costs and overheads has aggravated this problem (para 4.16).

4.15 These portfolio problems have had an adverse impact on the development banks' financial performance. As shown in Table 4.6, the financial performance of the three major development banks has been unsatisfactory due to the poor performance of their portfolios. The liquidity positions of these institutions have come under increasing pressure; (for example BAPINDO's current ratio, at the end of 1983, of 0.98:1 was below what is considered to be desirable). Moreover, very low profitability has precluded the provision of necessary reserves to support future growth. With their present portfolio condition, it would be very difficult for these banks to establish their creditworthiness in the market for resource raising purposes.

4.16 Shortage of Skilled Manpower. There is a general shortage of skilled manpower in Indonesia. But, this shortage is even more acute for the development banks who generally require well trained, high calibre staff such as financial analysts, engineers, economists and managers. The situation has been further exacerbated by the fact that in the last four years the Indonesian development banks expanded rapidly without a commensurate increase in their manpower. Thus, the economies in expenses <sup>/2</sup> have been achieved to some extent by not developing the size and capacity of staff (in terms of training and experience and knowhow), with serious consequences for institutional development. The shortage of skilled staff is a major constraint on the future growth of development banks and the development of sound portfolios. Recognizing this problem, BAPINDO and UPPINDO have instituted regular staff training programs. In addition, Bank Indonesia also sponsors a training program in collaboration with its Institute for the Development of Banking Industry (LPPI). These programs mainly provide elementary training in development banking and, therefore, both qualitatively and quantitatively fall far short of the needs of the development banks.

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<sup>/1</sup> State banks also can provide investment loans only to weaker economic groups; but, they lend a larger proportion of their portfolios as working capital (which include loans to stronger borrowers).

<sup>/2</sup> BAPINDO's overheads (around 2.5%) are well below those of state banks when they could be expected to be higher.

**Table 4.6: FINANCIAL PERFORMANCE OF DEVELOPMENT BANKS, 1980-83**  
(in percent) /a

	1980	1981	1982	1983
<b>BAPINDO</b>				
Net income before provisions for losses	3.3	3.7	3.9	2.9
Provision for losses	2.4	2.5	2.7	1.3 /b
Net income	0.9	1.2	1.2	0.8
Net income as % of average net worth (ANW)	3.0	5.0	7.3	6.0
<b>PDFCI</b>				
Net Income before provisions for losses	2.9	2.5	2.3	3.6
Provision for losses	1.1	0.9	2.0	3.0
Net income	1.8	1.6	0.3	0.6
Net income as % of ANW	12.3	13.8	3.5	9.2
<b>UPPINDO</b>				
Net income before provisions for losses	1.6	1.6	3.3	5.5
Provision for losses	-	0.1	2.5	2.7
Net income	1.6	1.5	0.8	2.8
Net income as % of ANW	3.8	5.4	3.8	16.8

/a As percent of average total assets, except where indicated otherwise.

/b BAPINDO's provision's for losses in 1983 was sufficient to maintain the total cumulative provision as a % of risk assets in 1983 (4.5%) at the same level as in 1982 (4.6%). However, given the declining portfolio quality, this level of provision will need to be reviewed.

Source: Development banks.

4.17 Operational Constraints. At present there are various operational restrictions on individual development banks. For example, PDFCI, UPPINDO and BAHANA were constituted as nonbank financial institutions (NBFIs) and, therefore, are not permitted to accept deposits, while BAPINDO can do so. BAHANA, as noted earlier is essentially confined to venture capital financing. Among these institutions BAPINDO has the maximum operational flexibility, but a policy of requiring it to finance projects of economically weaker groups exclusively restricts its ability to develop a balanced portfolio. These restrictions adversely affect the competitive ability of development banks in the longer term.

4.18 Suboptimal Scale of Operations. Development banks in Indonesia are characterized by considerable diversity in terms of size. BAPINDO is the only institution which is of a large size; it is in fact among the larger DFCs in the East Asia region. On the other hand, PDFCI and UPPINDO are among the smaller DFCs in the East Asia region, while BAHANA is clearly one of the smallest. Size variance is even greater among the RDBs. The larger RDBs with resource bases of Rp. 50-133 billion are comparable in size with some of the medium sized private commercial banks in the country; but the majority of the RDBs are very small; for example, the bottom 20 (out of 27) RDBs own only 36% of the gross assets of RDBs, and their average assets are only Rp. 17 billion./1

4.19 Several factors have contributed to the limited size of development banks, with the exception of BAPINDO. First, most of these institutions (except BAPINDO) were initially started with a modest capital structure which by and large has not since been expanded. For example, between 1979 and 1983, the combined paid in capital of PDFCI and UPPINDO increased by only 24% from Rp. 10.1 billion to Rp. 12.5 billion, while their total assets increased by 280% from Rp. 42.5 billion to Rp. 162.0 billion. The capital base of BAHANA has been particularly small. Second, the operational limitations imposed on/adopted by these institutions have also hindered their growth. For example, BAHANA is restricted to providing venture capital financing /2, and only to small and medium scale projects of economically weaker groups; these requirements have considerably restricted BAHANA's market. UPPINDO, on the other hand, until recently by design concentrated its operations only on small scale private sector projects. However, UPPINDO gave up this policy in 1983 and now seeks to diversify its operations and achieve more rapid institutional growth by lending also to medium sized projects. Similarly, growth prospects of RDBs have been limited by statutory jurisdictional constraints. As all-purpose banks owned and managed by the provincial governments, they have been required to perform commercial banking functions for, and act as treasurers of, the provincial governments; and consequently development banking functions have received lower priority. Limited access to long term resources and the lack of personnel trained in term lending have also limited development banking operations of RDBs. In addition, these banks are required to operate only in the provinces of their incorporation; and their growth prospects have varied according to level of economic development and resources of these provinces. It is highly doubtful that many of the RDBs, with their meager resources and limited growth prospects, will be able to play a meaningful role in promoting development of their respective provinces in the foreseeable future.

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/1 In December 1983 only 2 out of the 27 RDBs had total assets exceeding Rp. 100 billion; another 5 had between Rp. 50-100 billion, 5 more between Rp. 25-49 billion and 7 between Rp. 10-24 billion, while 8 had less than Rp. 10 billion.

/2 Originally BAHANA was required to provide equity financing only. The Government subsequently permitted BAHANA to provide a complete financing package (of equity and loans) to projects where it takes an equity position. In addition, BAHANA can finance only projects with a maximum size of Rp. 200 million, and preferably projects involving new technology.

### The Future Role of Development Banks

4.20 The recent performance and problems of development banks against the background of the reforms in the financial sector give rise to several important questions which are relevant to the future operations of these institutions and the further development of the financial sector: for example, is there a need for specialized development banking institutions in Indonesia at a time when the Government is encouraging the reform and broadening of institutions in the financial sector? If there is such a need, what should be done to make them more effective and viable institutions? This section of the chapter addresses these questions and seeks to outline a strategy to streamline and consolidate the operations of these institutions.

4.21 In the light of the analysis elsewhere in this report, development banks will still have an important role to play in Indonesia at least over the present decade. The commercial banks (both state and private banks), as discussed in Chapter 3, are hesitant to fully take over responsibilities of providing term finance. Although Chapter 3 outlines a number of steps to encourage commercial banks to undertake more term lending, this process will be gradual. As noted in Chapter 5, the capital market in Indonesia is also unlikely to provide a dependable and adequate alternative in this regard. In short, in the present transitional stage of the financial sector the availability of adequate medium and long term financing through commercial banks and the capital market is likely to be a problem, especially for new and smaller indigenous entrepreneurs. Such a situation may have potentially adverse consequences for project financing and overall investment in the economy, as it may lead to the postponement of some desirable investments, and compel some of the more eager entrepreneurs to resort to shorter term financing of long-term investment with the inherent risks of running into serious liquidity problems as and when the credit situation becomes tight. Neither development would be desirable from the viewpoints of promoting industrial development of the country, or sustaining investment and economic activity.

4.22 It would therefore be unwise to reduce the flow of long term credit from an important source of term finance at the present stage by doing away with specialized development banks. Despite their problems the development banks could provide an additional source of term financing (thereby supplementing term lending by commercial banks) even for larger borrowers over the medium term. In addition, the development banks could play an important developmental role through the appraisal and supervision of projects and technical assistance to smaller and new entrepreneurs who may lack sufficient knowhow and experience. These functions of development banks are still important, since the commercial banks are unlikely to develop sufficient capacity to provide such assistance in the near future.

4.23 Thus, the development banks could play an important role over the present decade both as providers of long-term capital and of specialized development support through project appraisal and technical assistance. Their role as important term lenders could be reviewed in a few years according to the progress commercial banks and the capital market make in this regard. However, in order to enable the development banks to play their expected role effectively, a number of structural changes are needed to build-up their institutional capabilities, strengthen financial viability and improve

long-term prospects. A phased program of reform should cover the following major areas: (a) future corporate strategy for development banks; (b) portfolio rehabilitation; (c) resource generation; (d) institutional upgrading; and (e) strengthening of RDBs. The recommendations (a) to (d) essentially relate to the nation-wide development banks (BAPINDO, PDFCI, UPPINDO and BAHANA).

4.24 Evolution of Corporate Strategy. In charting development strategies for the developmental banks two options need to be considered: first, to retain the present specialized character of these institutions; second, to convert them into general purpose commercial banks or universal banks. There are major trade-offs associated with each option.

4.25 A major objective of converting development banks into general purpose banks would be to make them independent of Government support for resources. However, there is no assurance that this objective will be achieved in the foreseeable future; in any event, given their institutional and portfolio problems, these banks will need considerable Government support to place them on a sound footing (para 4.34 below) before they can become competitive in the market. It will also involve some very real costs: First, if these banks are converted into general purpose banks a disproportionate amount of their management and staff resources would have to be devoted to the tasks of providing new activities and services to the public, at the expense of resolving their present institutional and portfolio problems. Second, it will divert attention from the basic function of these institutions, (project appraisal, technical assistance etc). Third, there is the danger that development banks themselves will be attracted into relatively low-risk but remunerative short-term working capital type lending, of which there is already an adequate supply in Indonesia. Fourth, given the shortage of skilled manpower in the country, it may be difficult for the development banks to find and attract the requisite quality and number of staff needed to organize, manage and operate commercial banking business; even if they succeeded in doing so, it would be at the expense of existing commercial banks which, from the national point of view, is not easy to justify.

4.26 On the other hand, the continuation of a specialised role for development banks will require continued government support; as discussed below, these institutions, even with organizational improvements, will be able to raise only a part of their funding requirements in the market over the medium term. However, given the stage of development of Indonesia's economic and financial system, it is still desirable to retain specialized development institutions in order to provide project financing, project appraisal and technical assistance to entrepreneurs. There is indeed a greater need now for careful selection of investment projects than ever before. Given the present levels of protection in the Indonesian industrial sector and pressures to increase import restrictions, there is a probability that divergences between economic returns and financial returns will increase. It is therefore important to ensure that resources are allocated to intrinsically sound projects with high economic returns through careful scrutiny and appraisal of projects. Such project appraisal and technical assistance can be best provided by financing institutions who also share in the financial risks. It is doubtful whether any non-financial government organizations (such as BKPM) can play this role, particularly for projects of relatively smaller size.

4.27 While retaining the specialized role of development banks, it is important, however, to encourage them to increase their capacity to mobilize resources from the market over time. However, this process should not undermine their primary function as specialized project financing institutions; this could be ensured by limiting the proportion of development banks' assets and staff resources that are to be devoted to functions other than development banking activities. This constraint could be gradually relaxed as commercial banks increase their term lending over time.

4.28 Portfolio Improvement. High priority should be given to efforts to improve the portfolio quality of development banks; this, and financial restructuring and funding arrangements discussed below are critical elements of a strategy to transform development banks into financially viable institutions. Several actions can be taken in this regard:

- (a) Special task forces should be set up within the development banks to review problem loans, and draw-up action plans to deal with such loans. An important objective of such a review should be to suggest practical measures to deal with problem projects: write-off bad loans, reschedule those which are likely to become delinquent, and make adequate provision for possible losses. BAPINDO should also work closely with its clients to facilitate financial and/or physical restructuring of problem projects. Where BAPINDO's portfolio has been adversely affected because of problems of state-owned public enterprises it has been required to finance, the Government should assume the responsibility for such loans. Special loan recovery units should also be set up, and action programs formulated to ensure loan recoveries.
- (b) Highest priority should be given to improving appraisal quality and strengthening appraisal capacity. As noted above (para 4.26), sound appraisal of projects is essential in a highly protected industrial sector, if BAPINDO is to avoid future portfolio problems. The emphasis of development banks should now be on consolidation, rather than expansion, of operations until such time as portfolio quality improves. BAPINDO, for example, should concentrate on strengthening credit departments at its Head Office and improving quality control and its screening mechanisms for appraisal rather than expanding its branch network and scale of operations.
- (c) Improve the quality and size of staff through hiring additional staff and staff training, particularly in loan appraisal and supervision work. The development banks should have more freedom in setting compensation packages for their staff at a level competitive with the market so that they can hire and retain high calibre professional staff. For the longer term, facilities for training in the field of development banking should also be expanded; in this respect the possibility of setting up a development banking institute, if necessary in collaboration with an experienced overseas university, should be explored.

4.29 There are important areas where the Government's assistance is also needed. First, to the extent that some of the portfolio problems of development banks are sub-sector specific (e.g., shipping and logging) rather than project specific, they can only be resolved through appropriate changes in government policies. Where such changes have been made in the broader national interest, subsector restructuring programs involving financial assistance from the Government to the enterprises affected would be needed. Second, in financing public sector projects, BAPINDO should have the operational freedom to choose the projects it finances on the basis of its project evaluation and assessment of credit risks. Third, the Government could streamline the legal system for recovery of loans. The present legal system is extremely complicated and time consuming; and this situation encourages willful defaults and places creditors in a very disadvantageous position. Moreover, the state banks (including BAPINDO) are required by law to go to the State Committee for Settlement of Credit Claims (PUPN) for loan foreclosures. Ostensibly, this mechanism was set up to speed up the loan collection process; but it has not been effective. The Government should review this situation and take appropriate steps towards simplifying the present legal system for loan foreclosures.

4.30 Resource Generation. Measures outlined above would help to reduce the deadweight of bad loans, improve cash flows and credit worthiness and facilitate development banks to raise funds from the market. However, it is unrealistic to expect that they could be self reliant in a short period of time; and development banks will need government funding for some time to come. Government support, either directly or indirectly (via government guarantees), is provided to development banks in many countries; for example, in Japan, Korea, India, Pakistan, Turkey, Malaysia, Singapore and Thailand.

4.31 It is desirable to conceive a strategy which would, over time, encourage the Indonesian development banks to reduce their reliance on government funding. To achieve this objective, a three-pronged approach could be adopted. First, long-term lending rates should be allowed to find their market equilibrium. This should enable the development banks to match their lending rates with their risks and collateral and differentiate between borrowers according to such risks. To the extent that risks of lending to smaller and inexperienced borrowers, and costs to the banks of providing technical assistance to such borrowers, exceed the average lending rates (for example to larger customers) these "developmental" costs may need to be directly subsidized by the Government.

4.32 Second, the financial structure of development banks should be restructured through the conversion of government loans into equity and the provision of additional equity by the Government as needed. This should serve two purposes. One, to build up the capital base of development banks; this is already quite small, and realistic loan write-offs and provisions for doubtful loans will strain it further.<sup>/1</sup> Two, an adequate capital base and improved cash flow should facilitate banks to keep down their average costs of blended funds and to borrow from the market.

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<sup>/1</sup> The amount of new capital infusions will also depend on the extent of write-offs and provisions that will have to be made following the review of loan portfolios suggested above, the desirable scale of operations for BAPINDO and the level of equity financing which BAPINDO should undertake.

4.33 Third, the Government should encourage development banks to raise funds directly from the market. Some options are: mobilizing time deposits and CDs at competitive rates, bond issues in the capital market, and direct placement of debentures and CDs with pension funds and insurance companies at market rates. These could be at variable rates as discussed elsewhere in this report. To be successful in issuing bonds, however as discussed in Chapter 5 below, the equalization of tax treatment between bond issues and bank deposits would be essential before development banks (or any others) could raise funds via the bond market. Development banks also may need government guarantees. They should also have continued access to external loans from multilateral agencies which are presently channelled through the Government.

4.34 It is possible to envisage a number of alternative combinations for blending of funds (from government equity, borrowing from external agencies and borrowing from the domestic market,) which would enable development banks to cover their lending costs, and still maintain a reasonable lending rate. Under such circumstances, further low interest loans to such institutions, as are presently provided to BAPINDO through BI liquidity credits, could be reduced substantially. Mechanisms should be put in place to reduce progressively the quantum of such loans and to gradually increase the interest rates charged on such assistance <sup>/1</sup>, so as to induce these institutions to increasingly mobilize resources through the market. One mechanism would be to provide such assistance on a matching funds basis. Institutions which mobilize more resources from the market would get more matching funds and would be able to expand their operations more rapidly; and each institution would be subject to similar operating rules and opportunities (para 4.35 below), to encourage competition and efficiency. The amount of such matching funds could be reduced progressively, and the rates charged increased over time.

4.35 Institutional Expansion and Upgrading. In addition, in order to encourage the growth of specialized development banks, it is desirable to remove operational restraints. Some of these banks are too small to undertake risks and spread them over a large asset base to keep down intermediation costs. As noted in para 4.19, the growth of the smaller development banking institutions (PDFCI, UPPINDO and BAHANA) has been affected by operational limitations placed on their activities. Some of these limitations have been inspired by good reasons (for example to ensure credit and institutional support to smaller entrepreneurs); nevertheless, they have hindered the growth of these institutions. Thus, it is desirable that the smaller institutions such as PDFCI and UPPINDO have the same opportunities as BAPINDO with regard to client selection, and institutional expansion (acceptance of deposits etc).

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<sup>/1</sup> The interest rates charged on, and the quantum of direct government assistance will depend on the level to which average costs of development banks have to be reduced and the particular blending of funds which is chosen.

4.36 Given the pressing need to increase the availability of equity capital in Indonesia, P.T. BAHANA should be substantially strengthened. As noted earlier, up to now BAHANA has not been very effective in this role. In order to play a more effective role, BAHANA should be reorganized, its operational jurisdiction increased (as suggested above), given substantial additional resources, and its staffing and technical capability to evaluate, assist and help manage enterprises substantially strengthened. An alternative approach would be to provide additional resources to the larger development banks (BAPINDO, PDFCI and UPPINDO) and encourage them to expand their venture capital operations. An important consideration, which should be taken into account in choosing between these alternatives, is that the project appraisal and supervision capacity and supply of technical staff in the country is limited. Consequently, it may be desirable to focus efforts to improve such capacity in a few institutions rather than to spread it too thinly.

4.37 Regional Development Banks (RDBs). The major constraints facing RDBs are the extremely small size of most RDB units, limited resources and limited opportunities to attain a reasonable scale of operations and become efficient. They function primarily as banks to provincial governments and do some development banking business, including participating in some of the special programs, i.e., KIK and KMKP.

4.38 Given their present situation, the emphasis in the development of RDBs over the next few years should be on improving their capacity to operate efficiently as banks and mobilize resources. Their capacity to provide development banking services to smaller borrowers at the local level should also be strengthened. There are two options in this regard: (a) merger of smaller RDBs into bigger inter-regional banks to make them more viable; and (b) association of smaller RDBs with nationwide commercial banks, with the latter entering into management contracts with each Regional Government to improve the quality of and expand the services being provided by RDBs. The first may not be practicable given the desire of each region to have its own bank. The second, by bringing in national commercial banks and utilizing their experience, may help to improve efficiency of the RDBs relatively quickly. Their capacity for development activities should be built up to prepare them for a more active developmental role. The improvement of staff quality and training, both for normal and development banking activities is a high priority in this regard. Consideration should also be given to setting up additional inter-regional training facilities, in addition to a central development banking training institute (para 4.28 above). To facilitate their ongoing development banking activities, since the smaller banks do not have adequate project appraisal and supervision capacity, it might be necessary to establish technical assistance service facilities. Such facilities are now being provided to RDBs by BAPINDO and UPPINDO. These could be expanded and provided, for a fee, by the national development banks as well as the national commercial banks who have such capacity. Finally, the RDBs will continue to be dependent, to a greater extent than the national development banks, on government support not only for development lending activities, but also for their normal operations. The emphasis on improving their banking operations should help to make them more self-reliant over time in this regard. In addition, they should be subject to similar pressures to mobilize resources that the nationwide development banks are exposed to, as discussed in paras 4.35 above.

B. Increasing the Efficiency of State Banks

The Level of Intermediation Costs

4.39 An important element which contributes to the presently high lending rates of state banks, apart from the increased cost of funds, is their high intermediation costs associated with their past development and efficiency levels. Intermediation costs (i.e., administrative costs, write-offs and other provisions) of state banks presently average about 7-8% of a loan. By contrast, intermediation costs in most developed countries are only 2-3% of loans, and in Singapore - the neighbouring financial market with which the Indonesian financial system has important linkages-only 3-4%. Since incremental costs of funds in Indonesia now average around 14-15% p.a. (Table 3.1 above), intermediation costs now approximate 30-35% of total loan costs./1

4.40 As Table 4.7 shows, there are principally two reasons for these high intermediation costs: high administrative overheads and large write-offs. These vary among banks, but on average 35% of intermediation costs are staff expenses and over 40% are loan losses and write-offs. These in turn reflect the effects of past government credit policies, as well as factors internal to state banks (see below).

Table 4.7: COMPOSITION OF INTERMEDIATION COSTS OF STATE BANKS, 1981-83 /a  
(In percent)

	1981	1982	1983
Overheads	56.5	62.7	54.2
Staff expenses	(35.4)	(37.6)	(30.5)
Other /b	(21.1)	(25.1)	(23.7)
Write-offs and provisions	43.5	37.3	45.8
Intermediation Costs	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

/a Excludes BRI.

/b Office expenses, depreciation, etc.

Source: Data supplied by banks.

/1 Prior to the June reforms, when state banks had virtually unrestrained access to BI's liquidity credits and to interest-free public sector deposits, intermediation costs indeed were even more important in the state banks' total lending costs.

### The Causes of High Intermediation Costs

4.41 These high intermediation costs of state banks reflect weaknesses in the organizational structure of banks; inadequate management and control procedures; deficiencies in credit initiation, supervision and recovery procedures; low degree of automation; overmann'ng; inadequate organizational and personnel planning to deal with these problems; etc. The banks are structured for reporting and are highly centralized, with large administrative bodies. They are, in general, overstaffed, on a rough estimate by about 25%.

4.42 The state banks, as noted in Chapter 1, have been operating under very different circumstances until recently, and are at present not generally geared for efficient operations in the new, more competitive environment. The present organizational structure, combined with inadequate internal controls, forces the management to limit the delegation of authority to departmental, regional and branch managers. Consequently most decisions are taken at the top level by the Board of Directors. This in turn leads to long delays in the approval of loans. The high degree of centralization is also to some extent the result of inadequate planning and budgeting procedures. For example, the planning and budgeting processes as yet do not clearly specify the banks' objectives and goals, resource needs and work plans to achieve these objectives, or targets and action plans for lower level managers for which they can be held accountable. The senior management also lacks management information systems which provide timely and reliable information on asset quality, liability trends etc. and help detect negative signs early. The audit system is not generally geared to the disclosure and analysis of control weaknesses in branch and departmental procedures which could put the bank at considerable risk, and its emphasis on routine procedures with low risks contributes to the inefficiency of head office and branch operations. Finally, automation which can improve information flows to the management, improve quality of customer services and considerably reduce the cost of bank operations, is still at a very early stage in all banks.

4.43 Many of these weaknesses reflect deficiencies in the organizational structure and control procedures and other shortcomings. For example, the head offices of banks, in most cases, are not organized on functional lines; there is no separation of line and staff functions. This has sometimes led to diffusion of responsibilities, lack of accountability and duplication of functions. Secondly, head offices and regional offices comprise 25-30% of the banks' total staff, but the benefits provided by them to the branches are not commensurate with their size. For example, in some banks, the regional offices are mini Head Offices, whose principal function seems to be the collection, compilation, and transmissiion of data, as well as checking of branch activities - much the same functions the Head offices themselves generally perform. Because of this duplication at regional and head office levels, per asset overhead expenses are generally high. Thirdly, a substantial amount of bank staff and time are taken up by report generation and review. For example, each branch on average prepares nearly 120 reports per month. To some extent, the plethora of reports reflects official requirements and a low degree of automation. But even where some branches have been computerized (or reports are no longer needed) manual reporting activities continue.

4.44 The high write-offs reflect organizational weaknesses as well as deficiencies in credit initiation and management processes, and insufficient loan supervision and recovery efforts. All banks have detailed procedures outlining credit analysis and approval processes. But, there is insufficient emphasis on the assessment of risks and developing sufficient knowledge of customers or their businesses, as against adherence to written procedures. The credit initiation process for the KIK and KMKP programs is particularly weak. Because of the small amount of each loan and the large number of applications, little attention is given to the quality of credit analysis. Account officers, for the most part, have very limited contact with customers because they are over-burdened with administrative matters or have too many relationships assigned to them. Head office credit departments themselves add little to the judgemental aspects of credit risk analysis. Credit analysts generally lack access to information and studies on major industries they serve; (banks undertake such studies only infrequently, and generally do not attempt to assess prospects for industries with a view to forecasting weaknesses and/or areas of opportunity for bank operations).

4.45 Collection efforts by banks have been poor, and arrears, particularly under the KIK and KMKP programs, are high. Non-payment by borrowers under these programs seems to be the result of limited efforts by banks, and passiveness on the part of customers. The low levels of interest rates charged also act as a disincentive for borrowers to repay these loans. Although most of these loans amortize monthly or quarterly and require close supervision by banks, they do not provide such supervision. The banks generally leave the responsibility for collection to ASKRINDO - the credit insurance agency for KIK and KMKP - (para 4.46 below) or to the government collection agency. In other cases, repayment schedules are not realistic in relation to the earning capacity of borrowers. While proper credit analysis should have exposed these problems at the beginning, restructuring of such loans is now required.

4.46 The present credit insurance arrangements are a major reason for the lack of collection efforts by banks and high default rates. At present, 75% of all priority loans, (including KIK and KMKP), are automatically insured by ASKRINDO. /1 For this coverage ASKRINDO charges a 3% one-time fee for loans up to 5 years /2, which is shared equally by BI and the handling banks. Moreover, under present arrangements (since 1982) banks can directly debit ASKRINDO in respect of any claims without making serious collection efforts.

4.47 Under these arrangements, the banks' exposure to lending risks has been quite marginal. Consequently, such arrangements have been a major disincentive to banks to improve project selection and step-up collection efforts. They have also overburdened the government collection agency and

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/1 Priority loans to cooperatives are insured under a separate scheme managed by the Ministry of Finance.

/2 For loans over 5 years, the premium increases to 5%, shared on a 2:1 ratio between BI and the handling banks.

ASKRINDO. Banks' claims on ASKRINDO have risen sharply in recent years, by 50% in 1981, 124% in 1982 and at an annual rate of 90% in 1983. This trend has already undermined the financial viability of ASKRINDO, and will require remedial actions as discussed in para 4.57 below. The Government is expected to undertake shortly a study to review this situation and feasible options.

#### Measures to Reduce Intermediation Costs and Improve Efficiency

4.48 Substantial improvements in the organizational structure and operating procedures of the state banks are needed in order to make them competitive and efficient. There is indeed considerable scope for such improvements. In general, restructuring their organizations, improving management controls (to facilitate greater delegation of authority and enable senior management to plan future strategies), reducing personnel, re-training and reallocating staff to more productive uses, and improving credit initiation and collection procedures (to reduce loan losses) could have a significant impact on banks' intermediation costs. Increased automation would also contribute to lowering costs and improving productivity. At the same time state banks need to be more market oriented. New banking services and products would help to attract lower-cost funds and increase fee incomes and profitability. To that extent, banks will be in a position to pass on to their customers some of these improvements in the form of lower intermediation margins.

4.49 Over the years Bank Indonesia has made continued efforts to strengthen and improve the operational capabilities of the state and private banks. The state banks are also keenly aware of the need for further improvements. They themselves have already initiated efforts to improve their operational efficiency in a number of areas: for example the quality of the staff by expanding training programs both domestically and abroad, upgrading credit initiation by greater emphasis on loan risks and introducing the account management concept, and greater efforts to improve loan recoveries. One bank has gone further and undertaken a major review of its organizational structure and functions with a view to introducing significant reforms with assistance from foreign consultants. The state banks, moreover, already have many of the control mechanisms discussed below in varying degrees; but, these need to be improved and strengthened.

4.50 The state banks themselves could initiate most of these needed changes without the approval or intervention of the authorities. There are, however, actions, which contribute to the efficiency and profitability of the banking system which the authorities will need to take (paras 4.68-4.71). The implementation of these measures will take considerable time. However, in view of their impact on lending rates and the desirability of reducing the presently high lending rates in Indonesia, every effort should be made to implement these measures to bring down intermediation costs as quickly as possible. These measures are also discussed below.

4.51 Organizational Structure. Perhaps the most important way of improving the performance of banks is restructuring them into more rational organizations on functional lines. This will help provide greater delegation of responsibility, define individual accountabilities, eliminate duplication between departments, reduce excessive staffing and improve productivity.

- (i) Several Head Office departments might be consolidated to improve coordination and eliminate duplication; and the monitoring role of Head Offices carefully redefined. As banks are computerized, coordination functions of Head Offices will decrease; their role will then become more and more one of supervising the activities of field units and aiding them to become more productive.
- (ii) The designation of responsibility for the marketing function is very important. A marketing focus will permit banks to plan marketing strategies more effectively and expand account officers' responsibilities, so that they will be responsible for the larger borrowers while branches handle smaller customers. This would transfer credit decisions to those who are closest to the customers and are most knowledgeable of their business outlook. It would also enable the banks to monitor their profits on the most important customer relationships. One approach is to divide the branches or regions into geographical groups, under a Director who is fully responsible for marketing, and reporting directly to the President. The Director would also have the responsibility of coordinating the credit, operational and other functions for the group; but should not have other functions at Head Office.
- (iii) Most of the banks already have varying degrees of account management in their Jakarta Offices. These account officers could be placed under the senior marketing management, in centralized locations rather than in each branch. This would reduce the need for a separate credit department in each branch, relieve the branch managers from major account responsibilities, and allow them to concentrate on other important duties, including deposit mobilization.
- (iv) High level management of credit policies and procedures is essential. Credit policy would need to be centralized under one Director designated as Senior Credit Officer; (at present some banks divide the credit function among two or more Directors). The Senior Credit Officer should have the responsibility for creating, implementing and monitoring credit policy, and standing apart from other bank tasks to give the independence needed.
- (v) Banks would need to consider establishing profit and cost centers. This will help identify incomes and costs of individual units and enable management to monitor profitability of branches or units, and ensure closer control over expenses.
- (vi) To manage the branch network, the use of regional supervisors under the direct responsibility of senior line executives, as being practiced by some banks already, is recommended. They would supervise the operating aspects of the branches in their geographic regions, but not function as mini Head Offices.

4.52 Initial steps to be taken in 1985 to implement such reforms include: the inauguration of organizational studies; establishment of a centralized account management group on a pilot basis in Jakarta; assignment, where not already done, of specific customers to account officers; and, during the next budget cycle, require account officers to provide specific business plans for each customer including volumes of business and yield to the bank.

4.53 Management process. The management process of state banks needs to be improved to permit greater delegation of authority and to free up senior management to focus on management and future planning of their organizations. However, internal controls must be strengthened before senior management could effectively delegate authority downstream. The major areas which require attention are: (a) rationalizing organizational structure, as noted above; (b) a management information system that provides senior management up-to-date information to detect negative signs early and control asset quality; (c) a detailed budgeting process that forces managers to clearly set objectives, and the means to accomplish these objectives; (d) policy guidelines established by senior management detailing the processes operative within the bank, and (e) an efficient audit system that serves as a check on the bank processes and on the delegated powers. The state banks possess these controls in varying degrees; but they need to be improved as discussed below.

4.54 Financial Planning and Reporting. There are several weaknesses in the present budgeting systems of state banks. Currently these budgets are forecasts extrapolating present trends; they do not clearly state institutional goals or include realistic action plans for achieving those goals. The management information system as a tool which enables senior management to monitor progress towards these goals is also deficient. It does not tell the management the reasons for implementation shortfalls, or provide an adequate basis for judging performance of subordinates or branches.

- (i) The greatest need in this regard is for the senior management to establish specific and detailed bank objectives, and to ensure resources to attain these objectives. They will need to become more active in the planning process, review action plans and budgets with managers (in order to clarify accountability and to secure their commitment), and review progress at periodic (preferably quarterly) intervals.
- (ii) The development of a high quality management information system is a high priority; such a system could provide the management regular reports analysing trends and results at various levels: (product and service lines, key corporate customers, branches and broad business units). The establishment of profit and cost centers (para 4.51) would supplement this process.
- (iii) Given the size of their loan portfolios, it is desirable that banks develop customer profitability analysis and reporting. This will help to determine the income from major relationships and the "costs" to the bank for the services provided, and will also support the "account manager" approach planned by banks.

- (iv) Finally, to improve the effectiveness of financial planning and reporting processes, staff training needs to be strengthened (para 4.64 below). It is vital that officers and employees understand the objectives and underlying philosophy of these processes so that they can successfully interpret reports and analysis and make MIS a decision support tool.

4.55 Initial steps for implementation in 1985 include the following: launch an MIS enhancement plan; begin upgrading reporting systems; decide on formats of profitability reports; rationalize budget instructions; and develop a framework for training programs.

4.56 Credit Initiation and Management. Measures to correct weaknesses in the current credit process and improve loan recoveries are needed to improve the quality of loan portfolios:

- (i) Special attention is needed to enhance the quality of credit decisions by improving analytical skills and experience and judgement. (a) An adequate training program will need to be developed for both credit analysts and accounts officers. Banks should provide, in addition to the training courses presently in place, courses and seminars which emphasize judgemental aspects of credit analysis. (b) Credit analyses now conducted by banks focus mainly on various liquidity ratios; greater attention needs to be given to evaluating market trends, competition and prospects for products and industries; banks should also regularly undertake such market studies. (c) Cash flow analyses could be improved by greater emphasis on the dynamics of cash generation and potential for each key source of cash. (d) Given the limited expertise of auditing firms, each bank could standardize internally financial information received from major customers in order to facilitate good credit judgements.
- (ii) The banks will need to carefully analyze the markets they desire to approach and set-up detailed marketing programs. As industry studies and other data indicate weaknesses or opportunities, the account managers could respond accordingly, easing off or weighing potential in better areas. As noted earlier, the responsibility for the initiation of the credit process, including analysis and recommendations, ought to rest with account officers. The centralization of account management in special marketing groups would free up branch credit departments to focus on small loans.
- (iii) The banks should take a new approach to the granting and administration of small loans to ensure proper credit initiation and adequate supervision. Firstly, it is necessary to ensure sufficient contact between lenders and borrowers in order to assess the character of the small borrowers and their ability to generate cash to repay the loan. This calls for frequent visits by account officers to the clients and greater knowledge of their business. Secondly, clients should be put on notice early that they are expected to pay interest and principal on due dates or early action will be taken. Thirdly, the banks will need to strengthen their own collection and recovery capabilities, without relying on ASKINDO or the Government's collection agency.

- (iii) An aggressive effort to collect past dues is a high priority. Each account officer could prepare a collection program for past due loans, with specific action plans. Where the numbers of past dues are very large (i.e. with the KIK and MKP programs), special task forces will be needed. It should be possible, by reallocating staff from routine tasks in Head Offices and the branches, to mobilize the necessary staff for this work without hiring additional staff.

4.57 It is desirable that a review of present credit insurance arrangements be made with a view to increasing the stakes for the banks to improve their loan collection efforts. In this regard, consideration should be given to reducing insurance coverage provided by ASKRINDO below present (75%) levels; to enable ASKRINDO to adjust the premia paid by the banks to reflect the nature of risks it is asked to cover; and to pass on to borrowers the increased costs of insurance incurred by banks. Without such improvements, the financial viability of ASKRINDO is likely to be impaired further, and substantial infusions of Government funds will be needed to support ASKRINDO.

4.58 Steps for initial implementation in 1985 could include the expansion of the use of account officers and providing them credit and marketing training; and a very serious effort to collect past due accounts.

4.59 Audit and Control. The audit system can be improved by changing its emphasis from checking past work against written procedures and disclosure of individual errors to detection of principal risks, and assigning audit priorities in accordance with such risks; increasing capabilities for electronic data processing (EDP) audits; and greater emphasis in improving productivity in operational areas:

- (i) The function of the Inspection Department needs to be re-defined to deliver cost-effective programs which match audit resources against risks, and provide support to the management towards achieving corporate goals.
- (ii) The internal audit schedule (frequency, scope, timing) should be based upon the inherent risks of activities which are subject to audit. For this purpose banks need to establish a system of ranking each branch and department according to its risk characteristics, for example, the nature of activities performed by the unit and the share of each unit in the bank's assets, liabilities and earnings, historical trends in frauds, losses, operational problems, etc.
- (iii) The Inspection Department will need to assume responsibility for a customer confirmation program. Such independent verification, which is not done now, can often disclose critical control weaknesses and irregularities.

- (iv) Banks should continue their efforts to upgrade the quality of audit staff; special attention should be given, in selecting audit staff, to broad experience, ability to analyze and suggest solutions to operating problems, communicating skills and independence of mind. To ensure their independence, auditors should be assigned to a manpower pool rather than to designated branches, as currently done. It is also necessary to keep trained staff longer in their assignments. In addition, a formal training program in audit procedures could be instituted.
- (v) The EDP audit capability is weak in all banks. In view of increasing automation, this capability needs upgrading. Specific audit staff could be selected to specialize in EDP audits and given appropriate training; audit staff involvement in the development of new automated systems is also required to ensure that necessary controls and audit requirements are built in.

4.60 Initial steps for implementation in 1985 include: establishing a program for risk assessment of branches and head office departments, and the scheduling of 1985 audit programs on that basis; introducing audits on a surprise basis where not already done; setting out procedures for client confirmation; initiating a program for the development of quality auditors; and placing an auditor on the user committees of all systems programs subject to audit.

4.61 Automation of Operations. Automation is extremely important to state banks, given the complexity of their organizations, in improving productivity by rationalising operations, reducing personnel and costs, improving the quality and speed of banks services, improving internal controls and providing an adequate MIS. Automation in all state banks is still at an early stage; each bank, moreover, is pursuing a different approach.

4.62 The banks will need to review their system design methodology in order to avoid unnecessary costs and to ensure that future operational needs are adequately met. (i) For this purpose branch and head office operations should be rationalized before automating the operations. (ii) Banks would need to look ahead and plan what services and product they want to offer, expected clientele, service delivery environment and types of management information required before finalising systems designs. (iii) To minimize overall costs and ensure speedier implementation, the automation programs could be segmented into phases, and reviewed frequently by the senior and systems management. Steering committees can be set up to review plans for automation, and before that, user design committees established to help develop and monitor implementation of such plans. (iv) Given the shortages of qualified systems staff in the banks, it is essential that qualified outside experts (who are not sellers of, or tied to, hardware or software goods) are hired by banks. Some banks have already begun to do so.

4.63 Manpower Planning. Although the state banks are taking steps to adapt themselves to the changing environment in Indonesia, personnel departments are doing little to prepare the banks for improved performance.

4.64 To better prepare the banks for the new environment:

- (i) The personnel departments need to change from direct decision-making (i.e., on employees' salary increases, promotions and transfers), to policy making units which establish personnel policies that guide the managers.
- (ii) They could be required to develop action plans to support the banks' major financial and institutional goals.
- (iii) With automation and streamlining of operations of branches and head offices a substantial staff surplus will emerge. This should be foreseen and plans made to retrain and redeploy surplus staff. Banks also will need to review their present staff hiring policies. Given the present restrictions on state banks in shedding surplus staff, hiring of new staff should be limited so as to not to exacerbate the staff redeployment problem. As banks' activities expand over time, improved staff re-training and redeployment programs will help to absorb surplus staff productively and bring down personnel costs.
- (iv) In order to improve the quality of services, greater attention to developing staff specialities and career paths to staff in such areas as credit, funds management, systems development, branch operations and personnel is essential. For this purpose, some of the internal practices, (such as frequent transfers), need to be changed. Also, the capacities and talents of present staff should be better utilized through better matching of skills and jobs. Some banks are already processing computerized inventories of employee skills and payroll and employee information in order to access skills as needed. This concept can be adopted by all banks.
- (v) All banks have committed substantial money and time to staff training. The training program, however, can be geared to the present and future institutional needs through a carefully planned manpower program which fully utilizes the talents of present staff, retrains persons displaced by work rationalization, and meets specific training for future needs, in conjunction with outside hiring for those leadership positions or technical tasks where inside talent is not available.
- (vi) The banks can further improve the performance evaluation process. The latter could be used as a major tool in determining the timing and size of salary increases and promotions. In this context it would be desirable to introduce a system of management by objectives (whereby officers are judged by successful completion of objectives), identify employees in different categories and levels of performance, with adequate discussion between employees and evaluating officers on the evaluation of performance. The transition to such a system, however, will not be easy in Indonesia; nevertheless efforts could be begun to assess and reward good performance.

4.65 Initial implementation steps in 1985 include improvements to the personnel evaluation process (beginning at the officers' level); establishing an inventory of skills with a view to developing banking specialities; and adapting training programs to suit specific needs.

4.66 Funds Mobilization and Management. Measures such as those discussed above will help to reduce intermediation costs of banks. Banks will also need to take steps to keep down their cost of funds, which, as noted earlier, has increased quite sharply since June 1983. The banks have not displayed sufficient initiatives to moderate this rise in cost of funds by attempting to tap lower cost deposits, diversifying instruments available for mobilizing such deposits, and by improving the quality and efficiency of services provided to customers. Moreover, to the extent that the banks succeed in mobilizing deposits from smaller depositors in urban and rural areas, the vulnerability of the banks' deposits to potential periodic capital flights/speculative transfers of funds abroad would be reduced. This would in turn help the banks to expand the supply of credit and lower lending rates at the margin.

4.67 To improve funds mobilization and management, state banks will need to:

- (i) Create efficient organizations capable of meeting client needs at a reasonable cost to the client and at a profit to the banks through the above steps;
- (ii) As noted above, set up effective marketing programs supported by sound credit practices; this includes the pricing of the credit products at rates commensurate with the risks taken.
- (iii) Take steps to adjust the liability side of their balance sheets to match the requirements on the asset side. Given the recent shift of funds from core deposit accounts (checking and savings) and stable longer-term (two year) deposits to relatively shorter maturity time deposits, state banks must seek ways of attracting cheaper and more stable funds, particularly from sources which presently do not use the banking system. Banks could mobilize more demand deposits by reaching out to the middle classes in major cities by opening up branches in residential areas, and attract rural savings by devising and selling new products. Products presently offered by banks (checking and savings accounts) are constrained by limited acceptance of checks in the market, long delays at banks in cashing checks and limited withdrawal rights. Setting up special rapid service windows for cashing checks, improving the quality of services and environment in bank offices, the creation of savings accounts with unrestricted withdrawal rights, and longer-term CDS would help to attract new depositors. The banks could also set up payroll accounts and credit salaries above certain levels directly into employees' accounts in their own offices and through arrangements with major employers. The banks will need marketing expertise to develop programs to tap these markets.

- (iv) All banks have recently set up asset-liability committees (ALCOs) to improve their asset/liability management. Improving this process by providing stronger senior management commitment, adequate staff support and access to information and guidance in improving its analysis and outputs can considerably enhance the benefits to the banks from ALCOs in devising policies for funds management and use.

External Factors outside the Control of Banks.

4.68 Although the internal improvements discussed above will help the banks to become more efficient, there are other important factors which are outside the banks' control which affect their performance and costs and which should be addressed by the authorities in the broader interests of financial sector development.

4.69 One of the foremost constraints impeding the financial system is the low degree of financialization of the Indonesian economy (paras 1.3 and 1.4 above); a large part of the Indonesian population, including much of the middle class in Jakarta, is a casual or non-user of the banking system. While there are many reasons for this phenomenon, state banks themselves have done virtually no marketing to popularise the banking habit. However, there is now a serious need to educate the public in the benefits of the banking system. Bank Indonesia should take the lead in such a campaign, in the same way as it successfully campaigned to popularize Tabanas savings a few years ago. Banking could also be popularized through schools, while the Government, in making payments, could encourage the use of checks.

4.70 There are also a number of laws which are detrimental to banking and which could be modified to benefit banks without undermining banking controls. One such law is the requirement that banks should retain all documents for 30 years. This has added substantially to banks' costs, since considerable space is required for handling voluminous old records. The use of micro-film in lieu of original records would save the banks considerable expense and still meet the legal requirements for safe keeping of records. The banks are also deterred from making important investments or expenditures on fixed assets, by government restrictions on the amount of net income that can be used for such investments. Banks also need to obtain approval from the Government (which takes a long time) on all major expenditures, even when the amount is within the legally sanctioned limits. While the state banks do not need to have uncontrolled authority to use such funds, it is important to relax the present restrictions to give them more latitude and shorten the approval period.

4.71 Another area which will need review relates to regulations imposed by Bank Indonesia. Over the years several regulations have been issued. Many of these may be no longer applicable, but the banks continue, in some cases, to generate reports and internal controls based on these outdated regulations. A review of the existing regulations with the objective of selecting and communicating to the banks the regulations which are currently in effect and valid would be beneficial.

4.72 The number and complexity of reports required from banks by Bank Indonesia is not large. However, banks still spend a considerable amount of time in compiling reports. At some point in time, as both banks and Bank Indonesia improve their automation capabilities, it may make sense for Bank Indonesia and representatives of the commercial banks to get together to simplify the information transmission process. It may be possible, for example, for banks to present to Bank Indonesia once a month floppy discs or other media containing all information required by BI. The latter, on its part, should have programs capable of extracting from the material base (the discs) the information needed by its various departments. This would help to considerably simplify data requirements from and staff time devoted to it by banks.

4.73 The implementation of these changes both by the banks and the authorities will not be easy, since many of the changes will require difficult decisions, considerable time and effort, and commitment from the banks' managements. Nevertheless, actions to improve the efficiency of the state banks should not be postponed until major decisions on such important aspects as the organizational structure, functional responsibilities and personnel policies are made by the banks' managements. There are several areas where a number of actions can be taken in the interim, pending the adoption of major decisions by the banks' managements. Indeed it is essential that feasible steps are taken as early as possible if the banks are to begin to reduce their intermediation costs over the next few years.

Chapter 5

MEASURES TO REVIVE AND DEVELOP THE CAPITAL MARKETS /1

A. Introduction

5.1 The previous chapters of the report discussed issues relating to term transformation by commercial banks and institutional development in the financial sector from the viewpoints of increasing the operational efficiency of state banks and strengthening the capacity of specialized development banking institutions. It was argued that the banking sector (including the development banks) will continue to be the main source of long-term funds in Indonesia for quite some time to come and that the proposed measures would help to maintain the flow of long-term funds for investment, while supporting the process of financial deepening. At present, the capital market is a relatively minor source of long term finance, and recent changes in regard to the implementation of new tax laws have made equity and bond financing uncompetitive (para 5.11). But, given appropriate policies, it has the potential to become an important source of investment finance over the longer term. An active capital market can help to improve the financial structure of enterprises by strengthening their equity base and lowering their debt-equity ratios. This in turn can facilitate term lending by banks by reducing their lending risks to the extent that debt-equity ratios of borrowers improve. Moreover, an active capital market would enable development banks (as well as enterprises) to mobilize funds from the market as discussed in chapter 4 above; and increase the depth of the financial system. Measures to facilitate the development of the capital market are therefore an essential element of a strategy for the further development of the Indonesian financial sector.

5.2 Transforming the nascent capital market into an important source of investment finance, however, is likely to be a long and challenging process. A comprehensive report entitled "The Development of Capital Markets in Indonesia", which identifies the range of issues with respect to capital market development and puts forward suggestions that might be considered, has been prepared by the International Finance Corporation (IFC). Against this background, this chapter reviews the recent developments in the capital market and the factors which have impeded its development; and, as a matter of priority, focuses selectively on certain areas where actions can be taken in the short term in order to revive the capital market: (a) removal of fiscal disincentives, (b) regulatory/institutional issues, and (c) steps to encourage the bond market. Other actions which might be considered to facilitate longer term development of the capital market, for example through the creation of new institutions and instruments, are discussed briefly in para 5.23.

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/1 These are defined as markets for equities and term debt obligations with maturities exceeding one year.

## B. Growth and Development of the Capital Markets

5.3 The Indonesian capital market was established in the last decade with the objectives of mobilizing additional resources through non-bank intermediaries, broadening the ownership distribution of corporate capital by enabling domestic, particularly small, investors to acquire such assets, and diversifying and deepening the financial sector. Accordingly, several institutions were set up: the stock exchange was reactivated in 1977, after being effectively closed since 1958; a regulatory institution - the Capital Market Executive Agency (BAPEPAM) - was created to administer and manage the stock exchange; and a national unit trust - P.T. DANAREKSA was set up to promote capital market activities (by underwriting new issues and ensuring stability of share prices), and to broaden the ownership distribution of shares, (by issuing back-to-back certificates and mutual fund certificates to the public). A number of underwriters and stockbrokers have also emerged, particularly among the non-bank financial institutions which were created in 1974.

5.4 The progress that has been achieved since 1977 in developing an active equity and bond market has been very modest. As indicated in Table 5.1 below, at the end of 1984 there were 24 (mostly private sector) companies listed in the stock exchange with listed shares totalling Rp. 131 billion, equivalent to about 0.3% of the gross assets of the financial sector. Most of this limited activity took place between 1981 and 1983 and was associated with the partial sale of foreign joint venture equity in the local market. The beginnings of a bond market, actively supported by the Government through tax concessions at the time, also emerged in 1983; and bond issues by 3 companies totalling Rp. 225 billion had been made by December 1984.

5.5 The capital market, however, has suffered a serious setback in recent months. There was only one no new equity issue in 1984. The trading volume, prices and values of shares have registered a dramatic and persistent decline over the past year; trading volume has fallen from a peak of about 20,000 shares per day in 1982 to 4,900 shares per day in 1984, while the total value of shares traded declined from about Rp. 50 million per day in 1982 to only about Rp. 9 million per day in 1984 (Table 5.1).

Table 5.1 NEW ISSUES AND TRADING ACTIVITY IN THE STOCK EXCHANGE, 1977-84

Year	New Issues				Daily Trading Activity	
	Stocks		Bonds		Volume	Value
	No. of Issues	Value Rp billion	No. of Issues	Value Rp billion	No. of Shares	Rp.million
1977	1	3.4	-	-	149	1.6
1978	-	-	-	-	78	0.9
1979	3	25.1	-	-	499	5.4
1980	2	8.5	-	-	6,625	22.8
1981	3	37.9	-	-	11,376	30.1
1982	5	20.4	-	-	19,915	50.1
1983	5	21.8	3	94.7	14,031	40.4
1984	5	14.3	-	130.0 <u>/a</u>	4,939	8.7
<u>Total</u>	<u>24</u>	<u>131.4</u>	<u>3</u>	<u>224.7</u>	-	-

/a Additional issues of Jasa Marga bonds.

Source: Capital Market Executive Agency (BAPEPAM).

5.6 The development of the capital market has been impeded by a number of fundamental problems: Firstly, the economic and financial environment has not been conducive to the growth of the capital market in many respects. As noted in Chapter 1, interest rates charged by state banks before June 1983 were generally regulated by the authorities. The combination of low deposit rates and state banks' access to liquidity credits from Bank Indonesia and public sector deposits enabled state banks to keep their lending rates at relatively low levels - 12% p.a. or less for priority loans and around 13-13.5% p.a. for non-priority loans. As a result, companies (who were potential borrowers in the capital market) could borrow from state banks at these rates, and had little incentive to approach the capital market. Secondly, although the eligibility criteria for companies have not been excessively tight (para 5.20 below), raising funds through the capital market involves real costs to potential borrowers. For example, the requirements of two consecutive years of adequate profitability and unqualified audited balance sheets - perfectly legitimate and prudent conditions in order to protect investors' interests in a fledgling market - nevertheless means that companies which evade taxes would be exposed to substantial tax liabilities if they went public. To offset this disincentive, significant tax concessions in the form of reduced tax rates to companies issuing shares in the stock exchange were introduced in 1977. These tax concessions, however, were terminated recently (para 5.10). Thirdly, some of the operations of BAPEPAM - the Capital Market Executive

Agency - also have had an adverse impact on activity in the stock exchange (para 5.16). For example, BAPEPAM, in order to make new issues attractive to investors, generally sets prices of new issues too low (with the result that new issues have been generally oversubscribed). All these factors have discouraged Indonesian companies to go public. In effect mainly joint ventures /1, which, according to their terms of incorporation, had to divest and broaden their ownership by specified dates, have resorted to the capital market. Fourthly, the role of DANAREKSA also has had a negative impact on market development in the long run (para 5.17). DANAREKSA was set up to support the capital market by underwriting and holding new issues, and was subsequently charged with the responsibility of stabilizing share prices in order to protect savings of small investors. In performing this role, DANAREKSA has regulated share price fluctuations within narrow bands, thereby limiting opportunities for capital gains to potential investors and the growth of market demand on that account (para 5.17).

5.7 These problems have been exacerbated in the past year by the effects of the financial sector reform of June 1983, the tax reforms introduced in January 1984 (para 5.11) and the low levels of activity and profitability in the industrial sector. As noted in Chapter 1, interest rates on bank deposits are now as high as 18-20%. Interest earned from bank deposits, moreover, has been exempted from taxation. In contrast, dividend income from capital market assets, under new tax laws, is taxable. (As noted earlier, the tax concessions to companies for going public also lapsed in 1984). As a result, gross yields on capital market assets (before adjusting for risk) now need to be around 28-30% p.a. to be competitive with bank deposits; and at these rates raising funds through the capital market is not an attractive option to potential borrowers. In addition, the still depressed business climate - excess capacity, low levels of production and profitability, and the general lack of investor confidence noted earlier in Chapter 2 - have also contributed to the reduced activity levels in the equity market. The discriminatory tax treatment of capital market vis-a-vis bank deposits (para 5.11) has affected the bond market particularly adversely. Tax-exempt bond issues by public sector enterprises offering yields close to those on bank deposit rates were made for the first time in 1983, and met with a good response in the market. However, given the rise in bank deposit rates and the elimination of tax exemptions, there is now virtually no demand for bonds at interest rates which are comparable to those on time deposits, i.e. 18-20% p.a.

#### C. Measures to Revive and Develop the Capital Market

5.8 A number of measures will be needed in the near future to revive and encourage the further development of the capital market. These include (a) corrective actions to put the equity and bond markets on an equal footing with banking institutions in regard to tax treatment; (b) improving the regulatory framework; and (c) additional steps to expand the bond market. These are discussed below.

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/1 Only 5 out of the 24 companies listed in the stock exchange are fully Indonesian companies; the rest are joint ventures.

5.9 Removal of Fiscal Disincentives. The elimination of the present discriminatory tax treatment of capital market assets as compared to bank deposits is essential in order to revive the capital market. In the recent past two important fiscal changes which affect capital market development have taken place: the termination of tax concessions to companies which has reduced incentives to companies to go public; and preferential tax treatment of incomes from bank deposits which has made the latter more attractive to investors as compared to holding capital market instruments.

5.10 The Government in the past has provided several incentives to encourage the development of the capital market. Tax benefits in the form of lower rates of corporate income taxes (by as much as 44% of normal corporate tax rates) and the revaluation of assets without incurring additional tax liabilities on revalued assets were provided to companies which went public. The latter provision was amended in July 1982 by permitting tax-free revaluation of assets only to the extent of pre-determined indices for equipment, buildings, vehicles and land. The income tax concessions were eliminated in early 1984 as a part of the new tax reforms.

5.11 The tax reforms introduced in January 1984 eliminated virtually all special tax incentives for investment and for particular interest groups as a part of a strategy to broaden the tax base and simplify the tax structure.<sup>/1</sup> However, for a variety of reasons discussed below (para 5.13), the implementation of the tax reforms with respect to incomes derived from bank deposits with maturities up to two years has been postponed for a "temporary" but unspecified period by an administrative decision of the Minister of Finance. In effect, incomes derived from bank deposits with maturities up to two years are exempt from income taxes in the hands of recipients and from withholding taxes, while dividend incomes from capital market instruments are subject to tax. This differential tax treatment of incomes from bank deposits vis-a-vis interest and dividend incomes from term-debt instruments adversely affects the attractiveness of the latter. Since companies must ensure gross yields of at least 28-30% p.a. to potential holders of term-debt instruments, it is not attractive to companies to raise funds in the capital market. On the other hand, if gross yields on bonds were to be lower than these levels, potential investors would be attracted to time deposits because of the higher net yields, and greater liquidity and safety of the latter. This situation contrasts sharply with that prevailing in the capital market prior to June 1983, when the demand for bonds was generally high. Then the lack of incentives to companies to go public was probably the major deterrent to capital market growth.

5.12 To revive the demand for bonds it is necessary (though not sufficient) that they are placed on a similar footing with time deposits for tax purposes. This could be achieved in two ways: either by eliminating the special treatment of time deposits, or by extending the same privilege to bonds.

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<sup>/1</sup> For a review of the tax reforms see World Bank Report No. 5066-IND "Indonesia: Policies and Prospects for Economic Growth and Transformation", April 26, 1984.

5.13 The preferential treatment of time deposits is inspired by the desire to protect the incomes of small savers for whom time deposits are likely to be a principal form of saving, to enable state banks to be more self-reliant by mobilizing more deposits, and to avoid possible capital flight. However, while banks have had considerable success in mobilizing deposits, small savers have contributed to only a small proportion of this growth. As Table 5.2 shows, deposits of over Rp. 100 million represent about 75% of total time deposits of state banks; and accounted for about 75% of the increase in time deposits of these banks since end-May 1983. In fact, the bulk of the increase (69%) in state banks' time deposits was in deposits of Rp. 500 million and above. Thus, while the concession to small savers is useful in promoting such savings, the main benefit of the policy accrues to high income savers. There may be a case for limiting the amount of interest income exempt from tax liability on equity grounds. The question of capital flight is more difficult to handle. As noted in Chapter 2, deposit rates in Indonesia would have to equal deposit rates abroad plus some premium in lieu of expectations of exchange rate risks. If the returns to domestic depositors were to fall below this level, there is indeed some risk of capital flight, as recent experience suggests (para 3.21). On the other hand, if deposit rates were to be adjusted upwards to compensate for the loss of tax exemption, domestic deposit and lending rates will rise on that account. A decision to completely remove tax exemptions on time deposits, therefore, would have to be considered carefully.

Table 5.2: GROWTH OF STATE BANKS' TIME DEPOSITS BY SIZE, 1983-84  
(Rp. billion)

Size Group	May 1983	March 1984	Change	
			Amount	Percent
Below 100 million	355.7	767.3	411.6	115.7
100 million and above	<u>1,093.2</u>	<u>2,276.7</u>	<u>1,183.5</u>	<u>108.3</u>
100 - 250 million	(377.9)	(301.2)	(-76.7)	(-20.2)
250 - 500 million	(207.6)	(371.9)	(164.3)	(79.1)
500 - 1,000 million	(50.0)	(256.7)	(206.7)	(413.4)
1,000 - 10,000 million	(161.1)	(721.1)	(560.0)	(347.6)
10,000 million & above	(296.6)	(625.8)	(329.2)	(111.0)
Total Time Deposits	<u>1,448.9</u>	<u>3,044.0</u>	<u>1,595.1</u>	<u>110.1</u>

Source: Bank Indonesia.

5.14 While the alternative of extending tax exemption to bonds carries with it the danger that it may trigger demands for special treatment of other interest groups (which should be resisted in order not to undercut the tax reforms) the equalization of tax treatment of capital market instruments and bank deposits could be considered on the following grounds: (a) Banks, at present real interest rates, are able to attract deposits far more readily

than capital markets can attract potential investors; banks also have other options and instruments to mobilize deposits as discussed in para 4.67 above. Some shift of time deposits to capital market assets thus will not necessarily hurt banks. It will in fact exert more pressure on banks to seek deposits more widely, thereby improving overall financial resource mobilization, and promoting the diversification of the financial system.

(b) As with protecting smaller depositors with banks, encouraging smaller investors and broadening ownership distribution are important objectives of capital market development. (c) The potential benefits from mobilizing additional resources and promoting the deepening and diversification of the financial system through capital market development far outweigh the potential revenue losses from equalizing tax treatment of bonds with that of time deposits. In fact, such revenue losses are likely to be negligible because some present holders of bank deposits (such as pension funds and insurance companies) who might switch funds from time deposits to an improved capital market, are already tax-exempt.

5.15 In summary, the authorities face a dilemma of how to remove the fiscal hurdles impeding the growth of the capital market without adversely affecting the mobilization of time deposits or the implementation of the tax reform. On balance, it would appear that a temporary tax exemption for bonds is desirable in order to encourage capital market development. Such an exemption could be withdrawn later on depending on the growth and maturity of the capital market and the increased acceptability of capital market assets to investors. The removal of tax exemptions on bonds in turn may provide the Government with a convenient opportunity to reconsider existing exemptions on time deposits.

5.16 Reform of Institutional/Regulatory Framework. Modifications to the prevailing regulatory framework in the capital market would also help to increase market activity levels. The objectives of such modifications would be to: (a) increase the scope for market determination of prices for new public issues to make the capital market attractive to issuers, and (b) expand opportunities for capital gains in order to increase the attractiveness of capital market instruments to investors.

5.17 BAPEPAM, the Indonesian capital market executive agency responsible for the regulation and operation of the Jakarta Stock Exchange, is actively involved in (i) the pricing of new issues (along with DANAREKSA, the national investment trust), (ii) the determination of the timing and priority of new issues, and (iii) the formulation of underwriting and sales commission structures. These interventions in the early stages of market development had been aimed at ensuring placement of new issues in an orderly manner, and to ensure strong demand for new issues. However, these have led to several drawbacks. Firstly, because prices have been set too low, (before the recent downturn in the market, the limited number of equity issues was invariably over-subscribed), there has been concern on the part of potential issuers that their securities will be undervalued, and therefore skepticism about going public. In addition, DANAREKSA by law has a preemptive right to purchase 50% of any new issue - a right which it has generally exercised - and to function as an underwriter of any new issue. In the early days of the market, this arrangement helped underwriters to place the larger issues particularly

because DANAREKSA would almost automatically take up half the new offerings. However, DANAREKSA's dominant role and BAPEPAM's intervention have generally weakened the bargaining power of underwriters and reduced their underwriting incomes. In effect, central aspects of underwriting functions have been taken out of underwriters' hands, and subjected to administrative rather than market judgement; this has hampered the development of genuine underwriting.

5.18 DANAREKSA has also generally used its predominant market position to stabilize stock exchange prices within narrow bounds. This policy again had been aimed at preventing sharp fluctuations in share prices to protect the infant market from speculators and market manipulators. However, it led to an unusual degree of price stability, and as a result, opportunities for capital gains have been limited, thereby eliminating one of the most powerful incentives to attract investors into the market. Indeed, DANAREKSA has tried to make its shares a close substitute for time deposits by maintaining dividend yields about 100 basis points above time deposit rates. This has essentially given the Indonesian equity market a dividend yield rather than a total yield (dividends and capital gains) orientation; it has also led to low equity valuations and high dividend payout policies and acted as a disincentive to the issuance of equities.

5.19 In order to make the capital market attractive to potential borrowers and investors (by providing greater scope for market determination of security prices and opportunities for capital gains) and to encourage development of underwriting, several steps could be taken:

- (i) BAPEPAM should gradually and in a phased manner withdraw from active involvement in the pricing of issues, the timing and order in which issues are brought to the market, and the determination of underwriting and sales commissions. These matters should be allowed to be negotiated between the issuers and underwriters. BAPEPAM thus should be focusing on its primary function i.e. administering the operations of the stock exchange and ensuring observance of eligibility criteria and other market regulations.
- (ii) DANAREKSA's preemptive right to acquire 50% of any new issue should be terminated. This would still leave DANAREKSA free to operate as an underwriter; but it would provide an equal opportunity for all underwriters (including, but not necessarily predominantly, DANAREKSA) to purchase new issues. This should not seriously weaken the market, since there are already a number of Indonesian merchant banks (NBFIs) which are well capitalized and have technical capability to fulfill underwriting functions. DANAREKSA's continued presence in the market as a major purchaser would still enable the pursuit of the Government's objective of broad-based ownership of companies.
- (iii) It is desirable that DANAREKSA's market stabilization activities are phased out. The rationale for this role (i.e., to prevent speculation and manipulation of the market and to protect the interest of small savers) are not compelling justifications in the

present context. Small savers who do not want to take risks now have attractive opportunities for obtaining high returns by acquiring time deposits. Broad-based ownership of corporate equity can be encouraged in the longer term only by creating conditions which will make it worthwhile to provide risk capital, and for this purpose increasing opportunities for capital gains and higher overall yields for investors is essential. Secondly, the authorities' concerns about speculative dealing could be addressed by tightly controlling or prohibiting the purchase of securities on margin, insider trading, etc.

5.20 Encouraging the Bond Market. Measures discussed above would help revive and increase activity in both equity and bond markets. Additional steps could also be considered to facilitate the growth of the bond market.

5.21 Currently, a company is eligible for listing on the stock exchange if it (a) has an authorized capital of at least Rp. 100 million, of which at least Rp. 25 million is paid-up, (b) has been profitable in each of the two immediately preceding fiscal years, with after tax profit in the most recent fiscal year of at least 10% of shareholders' equity, (c) is proposing a public offering with a par value of at least Rp. 25 million, and (d) has independently audited financial statements for the two immediately preceding fiscal years with an unqualified audit opinion for the last year. Bond issues have similar requirements with the further proviso that the total amount of bond issues of a company cannot exceed 100% of net worth. These eligibility requirements are not restrictive, particularly in the initial stages of capital market development. But, they are tailored to the capital structure of industrial concerns and prevent financial companies, which have higher leverage ratios, from issuing bonds.

5.22 This constraint on the issuance of bonds by financial companies could be overcome by modifying the present debt-equity ratio requirement and supplementing it with a debt-service requirement. For example, BAPEPAM could set a debt-equity ratio of 6 to 1 and a debt-service coverage requirement (for example, net income before debt service and taxes should be an appropriate multiple of debt service expenses) for financial companies, in addition to the other prevailing eligibility criteria. Such a modification would help protect investors' interests and still enable financial companies to issue bonds. As the market for equities and bonds develop, BAPEPAM may want to consider introducing a second section in the stock exchange with lower eligibility requirements, for example with higher debt-equity ratios and lower interest coverage, in order to expand the number of companies in the market.

5.23 The bond market could be further encouraged by enabling public enterprises to issue bonds. To facilitate this, however, the equalization of tax treatment between capital market assets and bank deposits noted earlier is essential. In addition, government guarantees may be needed on some issues. Possible candidates among public enterprises for bond issues are those of a commercial nature, or those who can earmark part of their revenues for retirement of bonds, such as toll roads, electricity companies and other utilities. Also, consideration might be given to the sale of bonds by public

enterprises (who provide services to the public) to the potential beneficiaries of services to be provided by them. For example, PERUMTEL - the telephone company - might issue bonds to applicants for new connections who could be given priority in the installation of new services. A secondary market in such bonds could also be encouraged, for example, in the case of the telephone company, by pricing the issues at a discount and allowing the market to capture some of the monopoly/scarcity rents. Another area where a similar approach could be considered is housing.

5.24 Other Actions for Longer Term Development. Finally, a number of other actions might be considered to facilitate the longer term development of the capital market. In this regard, the key recommendations in the IFC report, in addition to the steps discussed above, are to: (i) promote insurance schemes and pension funds in the corporate sector and individual financial security plans (which would be the individual counterpart of corporate pension plans), in order to encourage savings and the demand for financial instruments; (ii) introduce new institutions such as investment trust/mutual funds (including investment trusts for foreign investors) and venture capital companies to fill perceived gaps in the capital markets; (iii) introduce new financial instruments such as floating rate obligations to address market uncertainties; (iv) expand the scope of audited financial statements, and assure adequate and timely disclosure and reporting requirements for both public and private companies; (v) broaden the criteria for listing issues on the stock exchange through the introduction of a second category; (vi) allow greater leeway to institutional investors to make private placements; and (vii) arrange for comprehensive training and technical assistance.

5.25 To sum up, it is difficult to see how a significant capital market could develop in Indonesia in the foreseeable future without some improvement in the present tax treatment of capital market instruments. The most important requirement in this regard is to provide capital market assets with the same tax exemption now enjoyed by bank deposits noted earlier. In addition, improvements in the regulatory framework could facilitate equity and market development. Furthermore, some public enterprises could be encouraged to issue bonds; but for this purpose government guarantees might be needed. Finally, other measures of a longer term nature would be needed as discussed in the IFC report.

The Monetary and Credit Projections

1. In order to estimate Bank Indonesia's ability to fund the special credit programs, it is necessary to form a view on the growth of demand for money base over the medium term. Such an exercise is particularly difficult at this point in time, since it is as yet unclear whether the financial reform introduced in June 1983 will lead to fundamental shifts in the demand for financial assets in Indonesia. At the time of writing, the financial reform is only 2 years old, a full set of monetary accounts is only available for the period until December 1984, and the absence of quarterly national accounts data means that it is not yet possible to detect whether there had been any statistically significant changes in the demand for financial assets. Consequently, a medium-term monetary forecast is unusually problematic at this juncture. Thus the results of the medium-term forecast, on which the present report is based, should be treated with caution and continually tested against new data as they become available.

2. A second point worth noting is that, from the point of view of predicting the demand for money base, it is more important to predict certain monetary aggregates than others. For example, under Indonesia's fractional system (ceteris paribus) a one percent increase in currency held by the public increases the demand for money base by 0.68 percent. Similarly, (ceteris paribus) a one percent increase in rupiah time and savings deposits would increase the demand for money base by only 0.097 percent /1. In order of relative importance the components of the reserve base forecast are the growth of non bank currency, demand deposits, rupiah time deposits and excess reserves.

3. The projection method employed was to break the demand for money into two parts: M1 defined as non-bank currency and demand deposits; and Quasi Money defined as savings and time deposits with the deposit money banks (DMBs). It was found that the following equations exhibited a reasonably good statistical fit over the 1969-82 period with R<sup>2</sup> of 0.995 and 0.988 respectively.

$$\begin{aligned} \text{Log } \frac{M1}{P} = & -3.8199 + 0.5096 \log (Y) + 0.085 \log (1+R) + 0.611 \log \left[ \frac{M1}{P} \right]_{t-1} \\ & (1.617) \quad (0.20) \quad (0.36) \quad (0.16) \\ & - 0.513 \log \left[ \frac{P}{P_{t-1}} \right] \\ & (0.115) \end{aligned}$$

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/1 Based on December 1983 relationships between money base and other monetary aggregates.

$$\begin{aligned} \text{Log } \frac{QM}{P} = & -6.41 + 0.636 \log(Y) + 3.559 \log(1+R) \\ & (2.05) \quad (0.234) \quad (1.354) \\ & + 0.846 \log \left[ \frac{QM}{P} \right]_{t-1} - 0.551 \log \left[ \frac{P}{P_{t-1}} \right] \\ & (0.167) \quad (0.280) \end{aligned}$$

where P = price level in the current year (based on the GDP deflator),  
 Y = GDP in constant 1980 prices,  
 R = interest rate on 3 month time deposits,  
 t-1 = previous year's observation.

Standard errors of the estimates are shown in brackets below the respective coefficients.

4. These equations were then used to predict the demand for M1 and Quasi Money during 1983 and 1984. Since the demand functions for M1 and Quasi Money appear to have changed somewhat since the June 1983 reforms, the equations were accordingly modified to bring the predicted outcomes more closely in line with the observed outcomes. This enables the equations to capture some of the effects of the June 1983 reforms more successfully. Such a process should be repeated continuously as new data become available, in order to improve the performance of the equations as predictors of the monetary aggregates. In the case of M1, the constant and income terms were modified slightly and the interest rate variable (which was not statistically significant) was dropped. This resulted in the following equation:

$$\text{Log } \frac{M1}{P} = -3.92 + 0.508 \log Y + 0.611 \log \left[ \frac{M1}{P} \right]_{t-1} - 0.513 \log \left[ \frac{P}{P_{t-1}} \right]$$

5. Compared with the previous equation, this model suggests a downward shift in the M1 demand schedule and a lower elasticity of demand with respect to GDP. Both modifications are consistent with what economic theory would predict. The downward shift in the demand reflected in the constant term shows the portfolio effect of the shift from demand deposits to time deposits, as a result of the liberalization of deposit rates. The reduction of the variable in the income term shows the long term effect of the increased incentive to conserve on the transactions demand for money balances, stemming from the reform.

6. For the Quasi Money Equation it was found that the income and interest rate coefficients needed to be modified slightly to improve predictive performance. The following relationship was found to work well.

$$\begin{aligned} \text{Log } \left[ \frac{QM}{P} \right] = & -6.41 + 0.626 \log Y + 2.7 \log(1+R) - 0.551 \log \left[ \frac{P}{P_{t-1}} \right] \\ & + 0.805 \log \left[ \frac{QM}{P} \right]_{t-1} \end{aligned}$$

7. Compared with the historical statistical relationship the equation suggests a somewhat lower income elasticity and interest rate elasticity of demand for quasi money than before the reform. The reason for this change might be that there was a large portfolio adjustment in favor of quasi money in the period immediately following the reform.<sup>/1</sup> However, this adjustment appears to have largely run its course by the end of 1983 and a new relationship between GDP growth, interest rates and the demand for Quasi Money appears to be evolving.

8. The next step in the monetary forecasting exercise is to make some assumptions about GDP growth, nominal interest rates and inflation during the forecast period. Appendix Table 1 shows the assumptions used to prepare the monetary forecast.

Appendix Table 1: INFLATION, GDP GROWTH AND INTEREST RATE ASSUMPTIONS,  
1984-88  
(in percent, per annum)

	1984	1985	1986	1987	1988
Inflation rate	9	9	8	7	6
Real GDP growth	6.5	2.9	4.6	5.1	4.7
Nominal interest rate <u>/a</u>	19	18	17	16	16

/a 3 month time deposits.

Source: World Bank staff estimates and projections.

9. Based on these assumptions, the forecast for M1 is shown in Appendix Table 2. In order to ascertain the impact of M1 growth on the demand for money base, it is necessary to estimate the components of M1 (currency held by the public and demand deposits) separately. This is because the former is part of the money base. On the other hand, the DMBs need only hold a proportion demand deposits - currently 15% - as required reserves (which also constitute part of the money base). For the purposes of the projection it was assumed that the share of currency held by the public in M1 would remain stable at 43%. It was also assumed that the reserve requirement for demand deposits would not change. The forecast methodology predicts the average demand for M1 during the year. In order to find the level of demand

/1 As noted in Chapter 1 the growth of time and savings deposits during June-December 1983 cannot be completely attributed to the interest rate deregulation. It was also perhaps partly due to a renewal of confidence in financial savings stemming from the adjustment policies introduced in the first half of the year (greater fiscal restraint, devaluation and the investment rephasing).

at the end of each year the average of the preceding and following years was used. Thus nominal M1 for December 1984 is equal to half of the average nominal M1 for 1984 and 1985.

Appendix Table 2: PROJECTIONS OF M1, 1983-1988  
(Rp. billion; End December)

	1983 Actual	1984 Actual	1985	1986	1987	1988
Real M1 ave.	5,764	5,756	5,892	6,151	6,521	6,949
Nominal M1 ave.	7,529	8,195	9,143	10,310	11,693	13,210
Nominal M1 Dec.	7,569	8,581	9,726	11,001	12,452	14,016
Currency Dec.	3,333	3,712	4,208	4,759	5,387	6,063
Demand deposits Dec.	4,177	4,817	5,467	6,190	7,013	7,900
Required reserves ave.	629	672	740	833	946	1,072
Required reserves Dec.	627	723	820	929	1,052	1,185

Source: World Bank staff estimates and projections.

10. The same exercise was repeated for the projection of Quasi Money. In this case it is necessary to distinguish between rupiah time and savings deposits and foreign currency deposits. In the case of the former, the reserve requirement is in Rupiah (currently 10%) and consequently influences the demand for money base. The reserve requirements for foreign currency deposits are set in terms of foreign assets and do not affect the demand for money base. For the purposes of the projection, it was assumed that rupiah time and savings deposits would average 70% of total Quasi Money during 1984-88. Appendix Table 3 shows the results of the forecast.

Appendix Table 3: PROJECTIONS OF QUASI MONEY LEVELS, 1983-88  
(Rp. billion; End December)

	1983 Actual	1984 Actual	1985	1986	1987	1988
Real quasi money ave.	3,918	5,989	6,527	7,150	7,794	8,641
Nominal quasi money ave.	5,118	8,527	10,129	11,983	13,977	16,426
Nom. quasi money Dec.	6,983	9,331	11,056	12,980	15,201	17,649
Rupiah time deposits Dec.	4,694	6,387	7,739	9,086	10,641	12,355
Required reserves	469	639	774	909	1,064	1,235

Source: World Bank staff estimates and projections.

11. In order to prepare a forecast of total demand for money base one further assumption is required - the level of excess reserves held by the banks. For purposes of the projection exercise it was assumed that excess reserve holdings would decline from 36% of required reserves in 1983 to 25% by the end of 1984 and decline further to 15% of required reserves by 1988. The reason for this projected decline is that, as the sophistication of the domestic financial markets increases, banks have a greater variety of instruments available for investing their excess liquidity (most notably SBIs and the inter-bank market). Consequently, they can be expected to reduce their excess reserve balances with BI. Table 4 shows the results of the monetary forecast based on the foregoing analysis and assumptions. As can be seen from this table, the behavioral assumptions about the shift from currency to demand deposits within M1 and the projected decline in the excess reserve ratio imply a slow, but steady, rise in the money multiplier - the ratio of money base to M2 - so that the demand for money base is projected to grow more slowly than M2.

Appendix Table 4: PROJECTIONS OF MONEY BASE, M1, M2, AND MONEY MULTIPLIER, 1983-1988  
(Rp. billion; End December)

		1983 Actual	1984 Actual	1985	1986	1987	1988
Required reserves	(1)	1,096	1,361	1,594	1,837	2,116	2,421
Excess reserves	(2)	400	348	255	276	317	363
Bank reserves	(1)+(2)=(3)	1,496	1,709	1,849	2,113	2,433	2,784
Non-bank currency	(4)	3,333	3,712	4,208	4,759	5,387	6,063
Money base	(3)+(4)=(5)	4,829	5,421	6,057	6,872	7,820	8,847
M1	(6)	7,529	8,581	9,726	11,001	12,452	14,016
Rp. time deposits	(7)	4,694	6,387	7,739	9,086	10,641	12,355
M2	(6)+(7)=(8)	12,223	14,968	17,466	20,087	23,093	26,370
Multiplier	(8)/(5)=(9)	2.53	2.76	2.88	2.92	2.95	2.98

Source: World Bank staff estimates and projections.

### Credit Availability

12. The monetary forecasts can also be used to prepare an estimate of the potential level of credit which could be made available to the economy through the banking system. The methodology involves forecasting the growth and composition of the assets and liabilities of Bank Indonesia and the DMBs. The money base, M1 and Quasi Money forecasts provide a basis for these projections. However, a considerable number of additional assumptions have to be made, in order to prepare a credit projection. On the liabilities side, the money base accounts for only 25% of Bank Indonesia's total liabilities. Similarly, demand deposits and Quasi Money account for only 51% of DMB liabilities. Consequently, the growth of domestic credit is influenced by a significant number of factors, in addition to the growth of the major monetary aggregates. As noted in Chapter 2, two important factors determining the

growth of domestic credit are the growth of government savings with Bank Indonesia and Bank Indonesia's foreign exchange reserve targets. In addition, the choice of the DMBs between holding foreign assets and domestic lending is also a key factor in determining the multiplier effects of increases in Bank Indonesia credits, and consequently overall credit availability.

13. Thus, in order to make a credit forecast two steps are required. First, Bank Indonesia's balance sheet needs to be projected to show how much credit BI can make available either in the form of direct lending or as credits to the DMBs. Second, a projection of the balance sheet of the DMBs is needed. Appendix Table 5 shows the projection of Bank Indonesia's balance sheet for 1983-88. On the liabilities side, the money base forecast is based on the projection made in Appendix Table 3. It is assumed that government deposits will not change in nominal terms from their December 1984 levels and that deposits, capital and reserves and other liabilities will remain unchanged in real terms. On the assets side, it is assumed that Bank Indonesia's foreign assets would increase steadily from their December 1984 levels in line with the projections made in the recent Bank report on Indonesia.<sup>/1</sup> Credit to the Central Government is assumed to remain unchanged in nominal terms during 1984-88. This is equivalent to

Appendix Table 5: BANK INDONESIA BALANCE SHEET PROJECTIONS, 1983-1988  
(Rp. Billions, End December)

	1983 Actual	1984 Actual	1985	1986	1987	1988	Average Real Growth % p.a.	
							1983-88	1984-88
Foreign assets	6,433	9,169	9,448	10,086	11,301	12,463	6.3	0.9
Credit: Central Govt.	701	729	729	729	729	729	-6.2	-6.5
Direct credits	2,356	870	900	800	700	600	-16.6	-14.8
Claims on banks	4,365	6,938	7,573	8,154	8,282	8,527	6.5	-1.6
Other assets	2,885	3,912	4,244	4,563	4,859	5,126	4.5	.0
Total assets	16,740	21,618	22,894	24,332	25,871	27,446	2.8	-0.8
Money base	4,829	5,421	6,057	6,872	7,820	8,847	5.1	5.6
Currency	3,333	3,712	4,208	4,759	5,387	6,063	5.0	5.7
Bank deposits	1,496	1,709	1,849	2,113	2,433	2,784	5.4	5.6
Deposits (incl. FX)	757	467	507	545	580	612	-10.8	.0
Foreign liabilities	1,825	2,586	2,689	2,797	2,909	3,025	3.0	-2.8
Govt. current deposits	4,218	6,724	6,724	6,724	6,724	6,724	2.2	-6.5
Other Govt. deposits	913	564	564	564	564	564	-15.4	-6.5
Capital & reserves	459	593	643	692	737	777	3.5	.0
Other liabilities	3,739	5,263	5,710	6,139	6,537	6,897	5.2	.0
Total liabilities	16,740	21,618	22,894	24,332	25,871	27,446	1.4	-0.8

Source: World Bank staff estimates and projections.

<sup>/1</sup> World Bank Report No. 5597-IND: "Indonesia - Policies for Growth and Employment", April 23, 1985.

policy Variant I - Table 2.2 in Chapter 2. Direct credits are assumed to decline by Rp. 100 million annually during 1985-88. Other assets of Bank Indonesia are assumed to remain unchanged in real terms. This leaves claims on banks to be determined residually. This represents the amount of credit that Bank Indonesia could channel to the DMBs either through the priority credit program, open market operations, purchases of CDs or discount window facilities. Based on the foregoing assumptions Bank Indonesia credits to the banking system (claims on banks) would decline by about 2% annually, in real terms, during 1984-88.

14. A similar approach was used to project the balance sheets of the commercial banks in Appendix Table 6. The projections for demand deposits and

Appendix Table 6: PROJECTED CONSOLIDATED BALANCE SHEET OF DEPOSIT  
MONEY BANKS, 1983-88  
(Rp. Billion, end December)

	1983 Actual	1984 Actual	1985	1986	1987	1988	Average Annual Real Growth p.a.	
							1983-88	1984-88
Bank reserves	1,569	2,046	1,849	2,113	2,433	2,784	4.4	0.9
Foreign assets	4,520	5,107	5,718	5,939	6,192	6,456	.0	-0.9
Claims on Central Govt.	266	440	440	440	440	440	3.0	-6.5
Claims on public enterprises	2,884	4,543	5,051	5,682	6,414	7,246	12.0	5.0
Loans to private sector	10,058	13,401	15,867	18,508	20,945	23,691	10.5	7.8
Other private sector	440	695	787	901	1,032	1,178	13.4	6.7
Other assets	1,095	1,536	1,739	1,992	2,281	2,604	10.7	6.7
<b>Total assets</b>	<b>20,832</b>	<b>27,768</b>	<b>31,451</b>	<b>35,574</b>	<b>39,738</b>	<b>44,400</b>	<b>8.3</b>	<b>5.1</b>
Demand deposits	4,177	4,817	5,467	6,191	7,014	7,901	5.8	5.8
Time deposits	4,694	6,387	7,739	9,086	10,641	12,355	13.0	10.2
Foreign exchange deposits	2,289	2,944	3,317	3,894	4,560	5,295	10.1	8.2
Foreign liabilities	968	762	839	894	947	1,004	-6.2	0.1
Government deposits	778	1,397	1,516	1,629	1,735	1,831	10.5	.0
Import deposits	242	218	247	283	324	370	1.4	6.7
Bank Indonesia credits	4,264	7,045	7,573	8,154	8,282	8,527	7.0	-2.0
Capital and reserves	1,630	2,211	2,503	2,867	3,284	3,749	10.0	6.7
Other liabilities	1,790	1,987	2,249	2,577	2,951	3,369	5.7	6.7
<b>Total liabilities</b>	<b>20,832</b>	<b>27,768</b>	<b>31,451</b>	<b>35,574</b>	<b>39,738</b>	<b>44,400</b>	<b>8.3</b>	<b>5.1</b>

Source: World Bank staff estimates and projections.

Quasi Money are based on Appendix Tables 1 and 2. Import deposits, capital and reserves, other private sector claims, and other liabilities are assumed to grow 2.5% faster than real GDP and government deposits (including Central and local Government) are assumed to remain constant in real terms. Bank Indonesia credits to banks are taken from Appendix Table 5 (claims on banks). It was further assumed that foreign liabilities will rise by 5% per annum in nominal terms. On the assets side, bank reserves are based on the projection in Appendix Table 3. Foreign asset holdings of the commercial banks are assumed to remain unchanged in real terms from their December 1983 level. Claims on Central Government were assumed to remain unchanged in nominal terms. The assumption about foreign asset holdings is particularly strong as well as important, since it implies that increases in Bank Indonesia credits to banks and bank deposits (including a rising proportion of foreign exchange deposits) will be used for domestic lending. Claims on public sector and loans to the private sector are then derived residually. Although this analysis is admittedly rather mechanistic, it does serve to highlight the choice that both Bank Indonesia and the DMBs face between domestic lending and holding foreign assets; and, the trade-off between public sector and private sector lending faced by the DMBs.



