PECC Finance Forum Conference

Issues and Prospects for Regional Cooperation for Financial Stability and development

Hilton Hawaiian Village, Honolulu
August 11-13, 2002

Day One: Scope for Regional Financial Cooperation among PECC Economies

Financial Centers in East Asia: An Indonesian Perspective (outline)

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Description of Money and Capital Markets in Indonesia

Pre Crisis

The surge in capital inflow to Indonesia began only in the 1990s following the substantial liberalization program since the mid 1980s. Numerous studies, Gosh and Pangestu (2001) and de Brower (2000) among others, showed that financial integration in the Indonesia financial market is evident.

There are at least four main factors that shape the development of Indonesia's financial sector in general and its interconnectivity with other financial centers, post financial liberalization. They are:

- government financial policy and its enforcement;
- corporate governance;
- government macro policy, i.e., monetary, fiscal and exchange rate policies;
- external factors.

Following the 1988 banking deregulation, Indonesia's banking sector expanded rapidly. This development, unfortunately, was not matched by prudential regulations and improvement in the supervision capacity of Bank Indonesia (BI) to deal with the rapid increase in the number of banks and branches. But even after prudential regulations were introduced, problems such as the lack of enforcement of these regulations as well as weakness in the legal and regulatory framework remained.

In Indonesia, banks dominated the domestic financial sector. Based on 1996 data, net new bank lending amounted to IDR 58.3 trillion, compared to new IPOs and right issues of IDR 14.6 trillion and new bond issuance of 8.6 trillion. One estimate (Montgomery, 1997) also showed that the stock market had contributed to only about 15 per cent of total business finance, while the rest had been provided by the banking sector.

Refer to Kahlil's table (Table 1), size of capital markets, bonds etc

Box Capital Inflows, Increased Corporate Leverage Levels and Vulnerabilities

Financial integration has made offshore debt markets more accessible, whether it is through banks or directly through the issuance of commercial paper (CPs) and medium term notes (MTNs) to the corporate sector. The Indonesian monetary authorities introduced policies that have focused on the banks in particular. Banks have been subject to a limit on their net open positions (currently at 20 percent of capital for all currencies and 25 percent for single currencies) and their foreign borrowing has been subject to approval by the COLT. Indeed as Figure 1 shows, compared to corporations, banks have borrowed much less from abroad.

Figure 1: International loans, equity and bond issues by banks and corporations, cumulative 1990-96

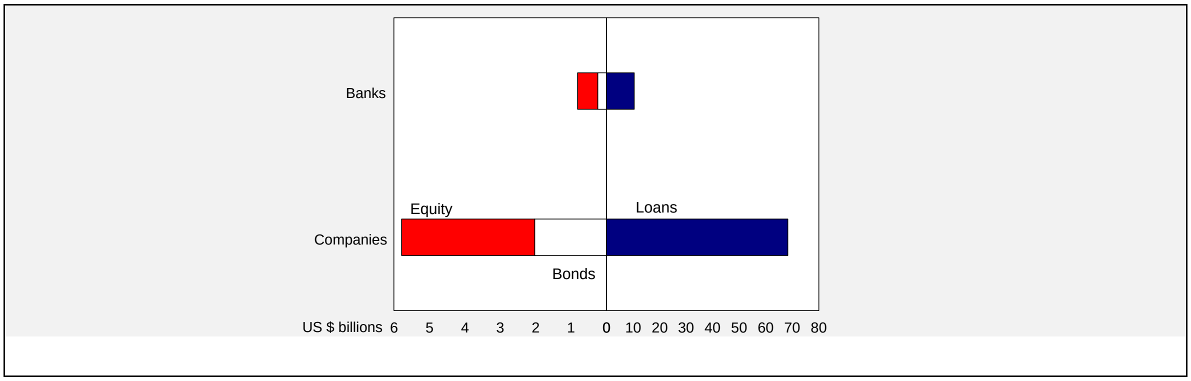

Table 2 shows in greater detail the nature and extent of private sector debt in Indonesia. The Indonesian industrial corporations –including stated-owned ones—have a remarkably bigger outstanding foreign debt at USD 65.3 billion. Out of the total USD 82.0 billion debts of the banking and corporate sectors, USD 72 billion or 87.8% of which are in the form of bank-lending and the rest, about USD 10 billion or 12.2% are in the from of marketable securities (commercial papers, medium-term notes, floating-rate notes).

Table 2: Indonesia's Total Foreign Debts (as of February 23, 1998)

SECTOR	BANK LOANS	SECURITIES (CP/MTN/FRN)	TOTAL
BANKING			
* State-Owned	5,910	1,370	7,280
* Private-Domestic	4,124	955	5,079
* Foreign/J.V.	4,330	--	4,330
Total Bank	14,364	2,325	16,689
CORPORATION			
* State-Owned	3,995	2,388	6,383
* Foreign Investm.	23,473	--	23,473
* Domestic Invstm.	30,120	5,313	35,433
Total Corporate	57,588	7,701	65,289
Bank + Corporate	71,952	10,026	81,978
GOI (direct)	--	--	54,110
TOTAL DEBT	--	--	136,088

Source: BI, reclassified.

Foreign borrowing increased rapidly in the period 1994-1997, before abruptly ending when the crisis started. The main “drivers” of the increased lending were the macro economic responses which made offshore borrowing less costly than domestic borrowing, and the issuance of the Central Bank’s Yankee bonds in 1996 which provided a benchmark for Indonesian entities. In addition, the late 1995 Central Bank regulation banning commercial papers issuance by finance companies had triggered a massive switch of their source of funding from on-shore to off-shore borrowings. Finance companies alone borrowed USD 5.1 billion in 1996, slightly more than 25% of total Indonesian corporations’ new debts issuance in the year, jumping from only about USD 819 million of new debts issuance in 1995.

Another factor that drove cross-border borrowing had been the relatively inefficiency of the domestic financial markets and the attendant high transaction costs of domestic borrowings. Table 3 compares the issuance costs of domestic debts (bonds, commercial papers and bank loans) and overseas loans. The most attractive instrument, in terms of the issuance cost, had been commercial papers (CP) –prior to the Central Bank’s tightening CP regulation in early 1996. The CP issuance process was much simpler and cheaper than other instruments. In addition, issuers had in the past the flexibility to roll-over their CPs when maturing, which made CPs as de facto medium-term notes. Overall, CPs had very competitive and low transaction costs: the estimated issuing cost for CP was estimated at about 50 to 100 basis points (bps) compared to 259 bps for domestic bonds, 179 bps for MTNs, 200 bps for bank loans, and 75 bps for off-shore borrowing. In addition, prior to the Central Bank CP regulation in 1996, banks could use investment in CPs as a vehicle to circumvent their legal lending limit. These developments had led to the booming of the CP market which capitalization almost doubled every year during the period 1989-1996, with a substantial proportion of which was believed to be held by foreign investors. Table 3, nonetheless, shows that off-shore debt markets had been much more efficient than the domestic ones, as reflected by their relative low cost of debt issuance.

Table 3: Comparison of Issuance Costs of Debt Instruments

	RUPIAH BOND	**Commercia l PAPER**	**MTN**	**Domestic LOAN**	**Off-Shore LOAN**
Benchmark Rate	ATD	SBPU	SBPU	SBPU	SIBOR
Risk Premium	100-200 bps	100-200 bps	200-300 bps	300-400 bps	150-200 bps
SWAP (p.a.)	NA	NA	NA	NA	700-900 bps
Processing Time Months)	6-8	1-2	1-2	1-3	2-3
Annualized Issuance Cost*	259 bps	50-100 bps	179 bps	200 bps	75 bps

Source: The World Bank: *The Emerging Asian Bond Market –Indonesia*, June 1995

(p. 3).

Note: SBPU: Central Bank's Money Market Notes
ATD: Average 12 months Time Deposits
* Assuming average maturity of 5 years for bonds; 3 years for MTN and one year for the others

Indonesian borrowers had in the past faced concerns over the quality of disclosures and market information. The absence of quality information regarding Indonesian entities had created uncertainty which investors could not hedge fully. As a result, investors had demanded compensation up front, in the form of higher premia to be paid. In the Yankee market in 1996, for example, an Indonesian entity with a double-B rating from Standard & Poor's or Moody's was charged with a 200-400 bps premium over T-Bill, compared to about 130-200 bps premium for US entities with a similar credit rating. The quality of disclosure, nonetheless, had improved. In 1993, Indonesia was ranked as having the poorest accounting standard among eight Asian countries including China, India, Korea, Malaysia, the Philippines, Chinese Taiwan and Thailand (IFC, *Emerging Stock Market Fact Book*, 1993). In 1996, however, there were more Indonesian listed companies (at 89%) audited by the Big-6 and their affiliates compared to 70% in S. Korea and Malaysia and 71% in Japan.

Interestingly, the rapid issuance of off-shore borrowing had also brought with it the economies of learning: the more Indonesian entities issued off-shore debts, the more they were able to deal with foreign investors and intermediaries and, thence, the lower transaction costs incurred. A comparison of the experience of the off-shore borrowing activity of two typical companies –one finance company (a non-tradable sector) and one export-oriented pulp and paper company – together with their attendant costs of borrowing is illustrative of this trend. While both companies where able to reduce the issuing costs of off-shore debts drastically in the period 1994-1997, they differed in their ability to lessen the burden of their coupon rates. The finance company was basically a domestic one and investors, intermediaries and the company were learning more about each other through on-going interactions during 1994-1997. Such an on-going market scrutiny and learning curve were reflected in the pricing of the debt security which lowered slightly from 205 bps premium over SIBOR in 1994 to about 171 bps premium in 1996.

The pulp and paper company, on the other hand, did not enjoy any significant saving in its coupon rates. Apparently, global investors had known the risk associated with the pulp and paper business –which was global in nature—and hence they had factored in already such a risk premium in their pricing. As a result, the coupon rate for the pulp and paper company remained almost constant in the period 1994-1997 with a premium of about 200 bps over SIBOR. Obviously, the better companies were always in a better position to secure access to less-costly debts everywhere in the global financial market; they were also the ones who benefited most from their experience to deal with global players in the market place.

In the aftermath of the crisis

Indonesia's financial sector suffered a big blow because of the crisis. A number of banks were eventually closed down and some were recapitalized. This section will assess financial development after the crisis and its impact on financial integration.

In particular, it will analyze the implementation of the banking-restructuring program announced in 1998. One important question that one may ask is whether there have been changes in the behavior of surviving banks compared to before the crisis and in what respect. Based on the loan to deposit ratio, it seems that banks remain reluctant to extend new loans. However, this may not be the case because they have become prudent in their lending activities but rather because they are responding to unintended incentives associated with monetary policy pursued by BI.

In addition, foreign banks operated in Indonesia are observed to be more prudent in giving loans than local banks. In this paper, we will also analyze the performance of foreign banks during the crisis. An important issue is how they cope with the crisis and compare that the strategy of local banks.

Another important related issue is the resolution of distressed external debts. The progress of the existing program in this respect will also be analyzed, especially with regard to corporate debt restructuring. An agency (Indonesian Debt Restructuring Agency, INDRA) and a task force (the Jakarta Initiative Task Force, JITF) were established to deal with this issue. We will assess the performance of these bodies.

Finally, the reverse trend of private capital flows since the crisis will also be analyzed. Subject to the availability of data, the interconnectivities between Jakarta and other Asian financial centers will be analyzed.

REFER TO TABLE

As a response to the current economic and financial crises, the government of Indonesia has issued new regulations to improve disclosure requirements. Privately-held, unlisted companies with assets of IDR 50 billion or more are now required to submit and publish audited reports by public accountants. Statistics on cross-border borrowings are now compiled and monitored regularly with stiff penalty for non-compliance. In the banking sector banks are now being audited by international accounting firms as a part of the on-going banking rehabilitation program.

2. Lessons Learned from Indonesia's Financial Reform

3. Recommendations

4. Conclusion

Table 1.

Financial Market Summary (Rp. Trillions)

Market Value, End of Period	1993	1994	1995	1996	1997	1998	June 1999
Bank Loans	150.3	188.9	234.6	292.9	378.1	487.4	251.3
Bond Market Capitalization	4.7	4.9	6.4	8.9	15.2	13.9	13.4
Stock Market Capitalization	69.3	103.8	152.2	215	159.9	175.7	416.1
SBI Outstanding Volume	23.3	15.1	11.9	18.6	14.9	58.8	50
GDP (current)	329.8	382.2	454.5	532.6	627.7	942.8	561.5
GDP (constant 1993)	329.8	354.6	383.8	413.8	433.2	376.1	183.7
M2	145.2	174.5	222.6	288.6	355.6	577.4	615.4
Number of Listed and Nondefault Issuers	16	24	37	38	49	41	36
Number of Listed Companies	172	217	238	253	282	288	275
SBI 1-month (%)	8.83	12.44	13.99	12.8	20	38.44	18.84
SBI 3-months (%)	9.3	12.7	14.25	14.13	12.25	39	23.33

Source. Rowter, Kahlil, Indonesia in Government Bond Market Development in Asia, 2001

Table 2.

NBFIs Compared to Banking Sector

		Number	**Total Assets**		
			Rp. Trillion	**Share**	**% of GDP**
Banks	Commercial Banks	239	389	86%	73%
NonBank Financial Institutions	Finance Companies	252	34	7%	6%
	Insurance	163	17	4%	3%
	Pension Funds	261	14	3%	3%
TOTAL		**9952**	**454**	100%	**86%**

Source. Ito, Sayuri, "Banking System in Indonesia", in Banking System in Asia,

Table 3.

Figure 1. Surge in private capital inflows, 1990-96

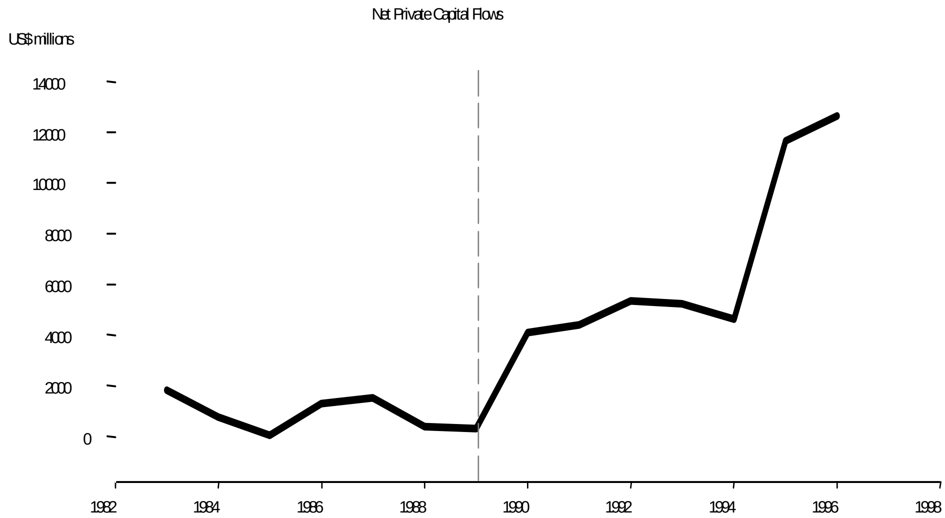

Table.
Private Capital (US$ million)

	1996	1997	1998	1999	2000
Private Capital, Net	**11,502**	**-338**	**-13,844**	**-9,926**	**-9,990**
A. Foreign Direct Investment	**6,194**	**4,677**	**-356**	**-2,745**	**-4,550**
1. Inflows	8,154	10,005	6,986	3,702	2,973
a. in cash	4,485	5,503	3,850	2,591	2,081
b. in kind	3,669	4,502	3,136	1,111	892
2. Debt repayment	-1,960	-5,328	-7,342	-6,447	-7,523
B. Domestics private	5,308	-5,015	-13,488	-7,181	-5,440
1. State enterprises	-1,736	-416	-1,517	1,036	-990
a. Pertamina	-955	318	107	-373	-511
- Inflows	526	680	496	16	171
of which non recourse (paid by products	524	675	489	16	171
- Debt repayments	-1,538	-438	-411	-389	-682
of which non recourse (paid by products	-1,520	-411	-401	-369	-616
- Export credit	57	76	22	0	0
= Oil	57	74	20	0	0
= LNG	0	2	2	0	0
b. Garuda	-16	-66	0	0	0
- Inflows	0	0	0	0	0
- Debt repayments	-16	-66	0	0	0
c. Others	-765	-668	-1,739	529	-479
- Inflows	1,214	1,030	557	1,651	251
= State banks	1,139	856	478	1,496	135
= Others	75	174	79	155	116
- Debt repayments	-1,979	-1,698	-2,296	-1,122	-730
= State banks	-1,902	-1,552	-2,209	-1,061	135
= Others	-77	-146	-87	-61	-81
d. Privatization	0	0	115	880	0
2. Other private capital	7,044	-4,599	-17,899	-11,704	-8,647
a. Inflows	5,571	6,905	2,682	3,548	3,596
- Offshore credits	5,520	6,854	2,648	3,321	2,329
= Private banks	1,148	1,581	764	2,363	1,139
= Non banks fin.inst.	530	439	112	119	90
= Other private enterprises	3,842	4,834	1,772	839	1,100
- Paid in capital (joint venture banks)	51	51	34	28	55
- Banking restructuring	0	0	0	199	1,212
b. Outflows	-3,532	-8,873	-18,579	-13,459	-10,332
- Offshore credits (debt repayments)	-2,932	-8,695	-18,535	-13,387	-10,182
= Private banks (incl.change in curr.dep.)	-1,194	-1,213	-5,304	-4,016	-2,438
= Non banks fin.inst.	-50	-752	-2,127	-1,509	-1,067

= Other private enterprises	-1,688	-6,730	-11,104	-7,862	-6,677
- Investment abroad	-600	-178	-44	-72	-150
c. Portfolio investment	5,005	-2,631	-2,002	-1,793	-1,911
- Issued domestic, net	1,819	-4,987	-4,495	-783	-1,022
= Equity	0	69	596	1,209	80
= Debt securities	0	-5,428	-5,091	-1,992	-1,102
- Issued abroad	3,186	2,356	2,493	-1,010	-889
= Inflows	3,366	3,871	2,706	0	0
= Outflows	-180	-1,515	-213	-1,010	-889
	0	0	0	0	0
3. Exceptional financing	0	0	5,928	3,487	4,197