FINANCIAL INSTITUTIONS AND POLICIES IN INDONESIA

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ANWAR NASUTION

INSTITUTE OF SOUTHEAST ASIAN STUDIES

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"I have been given authority over you
but I am not the best of you.
If I do well, help me,
and if I do ill, then put me right.
The criticism is considered a loyalty
and false applause is treachery."

Khalifah Abu Bakr*

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* As quoted by Nafisa, "Law and Social Change in Muslim Countries: The Concepts of Islamic Law Held by the Hanbali School and the Saudi Arabia Legal System" (S.J.D. thesis, Harvard Law School, December 1975), pp. 45–46, and Charles Himawan, *The Foreign Investment Process in Indonesia* (Singapore: PT Gunung Agung, 1980), p. *vi*.

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PREFACE

In his book *Economic Development* (New York: W.W. Norton, 1968), Benjamin Higgins labels Indonesia as "the number one failure among the major underdeveloped countries". Since then, however, the present New Order regime has turned Indonesia into a very different country. The regime has shown a remarkable record of success in formulating financial policies that have brought the country out of a period of economic stagnation, financial repression, and instability. Government policies reduced the inflation rate (which raged at 650% in 1967) to 9% in 1970, reformed the exchange rate system, and established the full convertibility of the rupiah in international transactions. The restoration of stability was the result of greater control of growth of money supply through the avoidance of budget deficits financing, decontrol, and return to a more market-oriented economic system. This helped to restore the attractiveness of holding financial assets through real positive interest rates, renegotiation of foreign debts, and liberalization of a foreign exchange system as well as devaluation and unification of the exchange rate, and created favourable conditions to attract both capital inflows. In terms of financial development, these reforms reduced the repression of the financial market. As a result of these policies, the ratio of liquid assets (ratio of broad money) to GNP, gross national savings, and gross domestic investment were all increased remarkably during the 1970s. Above all, the economy has been growing respectably.

As the economic stabilization programme was successfully achieved, the government turned towards a more diversified development effort with objectives relevant to employment and equity. At the same time, Indonesia's foreign exchange assets were continuously increasing during the 1970s due to an increase in its non-oil exports as a result of a short "boom" in the international economy at the beginning of the decade and an escalation of oil prices since 1973. Most of these foreign exchange assets are in the hands of the government. Government oil revenue from corporation taxes paid by foreign oil companies and other revenues collected from foreign firms and personnel are not withdrawals from the income stream of the domestic private sector (withdrawals from domestic purchasing power), since it would otherwise have been repatriated abroad. On the expenditure side, the government has used some of this foreign revenue in rupiahs to purchase domestically produced non-traded goods for employment and equity programmes. Looking at it this way, the relevant transmission of the mounting foreign assets into the economy is not the balance of payments but rather the government budget, especially when the government keeps to its balanced budget policy. Under such conditions, to maintain price stabilization, the authorities treated credit of the banking sector as residual.

In order to reduce inflationary pressures that come mainly from a government budget, since April 1974 the monetary authorities have been imposing a more complicated and stricter credit ceiling than before. In the past, notably under the IMF stand-by arrangements, the credit ceiling represented no more than a commitment by the central bank to observe a limit to overall credit expansion. Under the new programme, the central bank sets ceilings of total credit and permissible increases in net assets of all banks. With the new programme, credit allocation has moved away from allocation through interest rate mechanisms to a more administratively determined system. In this system, the authorities direct credit towards individual sectors, through a system of programme and non-programme credit. Previously, monetary authorities were being asked to solve problems which they could not solve. They were assigned a civic function to restrict certain credit only to *pribumis* (indigenous people) and establish credit for pribumis as a priority in order to enhance pribumis' participation in economic activities.

The Indonesian financial system is dominated by the government-owned financial institutions. Since all government credit programmes are channelled through these institutions with guaranteed refinancing from the central bank, these institutions have been growing very fast. However, the credit ceiling means maintenance of their status quo, and with some discrimination against private banks, the system prevents competition among the financial institutions to reduce the cost of intermediation.

With massive increases in their foreign assets and adequate supplies of refinancing from the central bank discount window, while their credit was subject to ceilings, the state-owned banks were constantly overliquid in the 1970s. Aside from setting the maximum amount of credit expansion through a ceiling, the Bank Indonesia also set the level as well as the structure of interest rates. During the 1970s their levels, in real terms, were very low or negative. As a result of these repressive policies, most of the excess liquidities owned by foreign exchange banks and domestic savings have been transferred abroad to benefit from the high interest rates in international markets particularly at the end of the 1970s. People kept their savings in the form of imported gold or jewellery, or land and other physical assets. Capital outflow and an increased propensity to import non-essential goods have somewhat sterilized the increase in foreign assets, but in non-productive ways.

A boom in the oil sector reduced the terms of trade of tradable goods relative to non-tradables particularly as extra aggregate demand is confined mainly to the latter. Moreover, as the price of oil rises relative to the price of non-oil exports, the trade balance of the oil sector moves into a surplus and this leads to a combination of nominal exchange rate appreciation and capital inflows. Since the latter are not sterilized, they caused domestic inflation and a decline in non-oil export competitiveness. This so-called "Dutch disease" (Corden [1980] credits the *Economist* with the invention of the term) was cured by the devaluation of the rupiah in November 1978.

This study (a revised version of my Ph.D. dissertation "Macroeconomic Policies, Financial Institutions and a Short Run Monetary Model of the Indonesian Economy") analyses the Indonesian economy and financial sector since 1968, with special emphasis on the 1971–79 period. The study begins with a general overview of macro-economic developments (Chapters I and II), and moves on to a survey of financial structures in Indonesia and the monetary policies which have been followed (Chapters III and IV). Drawing on the literature concerning the role of money in open economies, a monetary model is presented, estimated, and used to simulate policy changes in Chapter V. Chapter VI provides some brief concluding observations.

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Lee Tucker turned illegible drafts into dissertation at Tufts, and Triena Ong, Editor/Manager, and her staff in the Publications Unit at ISEAS contributed to the reorganization of the chapters and to further improvements in style and language in the process of producing this book.

My parents and parents-in-law have always been supportive and encouraging, but it is to my wife, Ayuna, who has shared all the agonies of living abroad as a student's spouse, that I dedicate this work.