



Occasional Paper No. 76

# **Jakarta Dollar Market**

**A Case of Financial Development in ASEAN**

Njoman Suwidjana

**INSTITUTE OF SOUTHEAST ASIAN STUDIES**

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Published by  
Institute of Southeast Asian Studies  
Heng Mui Keng Terrace  
Pasir Panjang  
Singapore 0511

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ISBN 9971-902-84-2

ISSN 0073-9731

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## Acknowledgements

This monograph was written when I was a Research Associate at the Institute of Southeast Asian Studies (ISEAS), Singapore. The Institute has provided me with financial support and a conducive working environment and I am especially grateful to the Director, Professor K.S. Sandhu, for making this study possible. I am also greatly indebted to Prof. (Emeritus) H.W. Ardnt of the Australian National University for his constant guidance and encouragement, which have helped me immensely. My gratitude to him is beyond words. Other people have also helped to make the completion of this study possible. I would like to thank in particular Richard Gordon and Paul Dartnell, both of the Australian Embassy, Jakarta; Syahrir Sabirin of Bank Indonesia; and Donald E. Browne Jr. of Citibank, Jakarta, for their assistance in the collection of data and useful discussions. S.A. Grenville of OECD, Paris, Willem van Den Wall Bake of Morgan Guarantee Trust Company, Jakarta, and Slangor and Mukhlis Rasjid of Bank Indonesia have given helpful comments on the first draft of Chapter III; to them I am very grateful. Finally, to Aleth Yenko, many thanks for the support.

I am, of course, responsible for any errors and shortcomings in this study.

N.S.

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# I Offshore Currency Markets

The term “offshore” in the context of international financial markets has two broad perspectives — from the point of view of the *home* country (that is, the country where the currency is used), and from the point of view of the *host* country (where the financial market activities are located).<sup>1</sup>

From the home country’s point of view, foreign currency asset and liability operations of banks located outside the country in which that currency is legal tender are “offshore” to the issuing or “home” country. For example, U.S. dollar transactions of banks in Europe, Singapore, the Caribbean, and other places outside the United States are deemed to be offshore to the latter. Similarly, yen operations of banks located outside Japan are offshore to Japan.

From the point of view of the host country, a financial market is usually considered offshore (even if the transactions are performed by banks located in the host countries) in so far as:

1. these activities are performed in a currency which is not legal tender in the host country. Although in some cases, transactions in domestic currencies are allowed, an attempt is usually made to separate offshore activities from the domestic transactions through various ways, most commonly through the residential status of depositors or borrowers. For example, transactions with residents are channelled through the Domestic Banking Unit (DBU) of offshore banks, and conversely, transactions with non-residents through the Offshore Banking Unit (OBU) of domestic banks.<sup>2</sup>
2. some attempt is made to *separate* these activities from the domestic financial market. Very often, the two kinds of activities are subject to different sets of regulations such as no exchange control, no reserve requirements, and tax incentives.
3. these activities have a significant *non-resident component* — in fact, in most cases the markets are limited to non-residents. In some cases, residents are given access but usually only to a limited extent.

In practice, however, the division between the offshore and the domestic market is difficult to detect. This has, indeed, become increasingly so in recent years as many countries hosting such a market abandoned their exchange controls.



### Some Broad Features of Offshore Currency Markets

Offshore currency markets have a number of salient characteristics:

1. Transactions are mostly with *residents of other countries*. However, as more and more host countries have abolished their exchange controls, residents have also been gaining increasing access to the market.
2. *One party in the transactions is always a bank* while the other is often another bank, but it may also be a non-bank institution such as a business enterprise, an international organization, a government body, a central bank, or a wealthy individual. Low-income individuals are, in practice, though not necessarily, excluded.
3. *Inter-bank transactions* usually play a dominant part in the market, at least compared with the domestic financial market.
4. The size of each transaction is usually large, as to typify a wholesale market. Loan demands, in particular, are often of such a magnitude that they must be syndicated in order to spread the risks.
5. The market is generally subject to minimal or no direct governmental intervention — such as no reserve required, minimal or no exchange control, no withholding tax on interest, or other restrictions. Rates of interest, therefore, are determined by the market.
6. Because transactions between banks dominate, the rates for these transactions are usually held as “anchor” rates, to which deposit and loan rates are pegged. The latter are usually expressed as a constant margin to the former, be it LIBOR (London Inter-bank Offered Rate) or SIBOR (Singapore Inter-bank Offered Rate).

### Structure and Performance

In terms of structure and performance, we can distinguish at least four types of offshore currency markets: a) purely offshore currency market; b) offshore market with limited resident participation; c) offshore market with unlimited resident participation; and d) integrated offshore market.

In a purely offshore market, participants are restricted to non-residents. The role of financial institutions in this case is essentially intermediary, accepting deposits from and extending loans to residents of the third countries — strictly entrepôt activities. Transactions of this nature are neutral from the point of view of the host country's balance of payments, exchange control, and domestic monetary management as they do not constitute inflows or outflows of funds, nor do they involve domestic currency. The Panama offshore dollar market is a good example.<sup>3</sup>

In an offshore currency market with limited resident participation, residents are allowed to participate but within certain limitations, for which elaborate regulations are usually employed. Transactions with residents, whether they involve currency transformation or not, are usually treated as inflows and outflows of funds and, therefore, affect the balance of payment of the host country. One good example of an offshore market of this type is the Asian Dollar Market in Singapore prior to the liberalization of exchange control in 1978.

The third type of offshore market is an extended version of the second where resident participation is not subject to governmental limitations. However, the two markets are kept separate as each is subject to different sets of regulations, fiscal or otherwise. Here too, transactions with residents regardless of whether they involve currency transformation or not would affect the host country's balance of payment as they constitute inflows and outflows of funds. The post-June 1978 Asian Dollar Market and the Eurodollar Market after the liberalization of exchange control in the United Kingdom are two examples of this type of offshore market.

The fourth type of offshore market hardly deserves the name for in most cases the only common denominator it has with the other types of offshore markets is the currency used. This type of offshore market usually constitutes an integral part of the domestic financial system as it is subject to the very same rules and regulations and thus receives no special treatment, such as exemption from reserve requirements, tax incentives, no foreign exchange control, and so forth. Consequently, its impact on the domestic financial market is direct, and uncharacteristic of offshore markets. Two of the best examples are the Hong Kong offshore currency market and the Jakarta dollar market. The latter will be discussed to some length in this study.

### **The Development of Offshore Banking**

In the late 1950s, banks in Europe began to accept deposits and grant loans in currencies other than their own. The U.S. dollar was particularly favoured for it was the most stable and widely accepted currency. Depositors and borrowers were mostly non-residents in both the government and the private sectors. These activities constituted the *Eurodollar* market and was centred in London. Why and how the market came into existence will be discussed later. What is important at this point is to note that a) the prefix "Euro" merely indicated the geographical location of the market and b) the Eurodollar was an external market in the sense that its links with the domestic financial market were limited. It catered

mainly to non-residents and was not subject to domestic regulations such as exchange control, reserve requirements and other restrictions. Resident participation was deliberately kept to the minimum. Consequently, the market behaved quite differently from any of the domestic markets including that of the United States in spite of the use of the U.S. dollar.

In the early and mid-1960s, the market experienced a significant boost from flights of capital from the United States as a result of governmental interventions in the financial market, the most notable of which was the introduction of Regulation Q which prevented banks from paying competitive rates on deposits. London once again became one of the two largest financial centres in the world, second only to New York.

As most of the European currencies became convertible in 1968, the role of these currencies in the market increased. Soon Eurodollar became one (and the largest) of the many components of the *Eurocurrency* market.

In the late 1960s and early 1970s many offshore financial centres were set up outside Europe. A few developed “naturally”, that is, in response to market demand, but most came about as a result of active support and encouragement from their respective governments.

Countries sought to develop such a market for various reasons. Most were attracted by additional income from the export of financial services, and the “invisible” income which includes creation of new business opportunities and employment in the supporting sectors, and improvement in the efficiency of the domestic financial sector, but some sought to widen their access to the international financial market. Their success, however, was largely dependent on their ability to meet the various conditions essential to the development of such a market. Some of these conditions were:

1. Economic and political stability,
2. An efficient and experienced financial sector,
3. Good infrastructure, particularly the communications system,
4. A favourable business climate, characterized by sensible official regulations and attractive conditions (including fiscal, monetary, and other concessions),
5. Strategic location: proximity with customers and time overlap with other important centres, and
6. Availability of supporting services.

Even at a glance one can easily tell why the Eurodollar and the Asian Currency Unit (ACU) grew at such phenomenal rates. Of all the countries that sought to develop an offshore market, the United Kingdom and Singapore had the most attractive environment. The Caribbean would have been an ideal place too, but it lacked accommodative governmental

regulations. Panama, on the other hand, had several natural advantages, such as the U.S. dollar being legal tender, minimal exchange control, bilingual population, and strategic location, but it lacked political stability. Nevertheless, there are now more than a dozen offshore financial centres of some prominence in the world. As shown in Table 1, Europe remains the largest. In 1977, about three-quarters of the activities took place in London, Luxembourg, and Paris. The proportion, however, declined in recent years as a result of rapid growth experienced by centres outside Europe, more noticeably Canada, Tokyo, and Singapore. Today, Singapore hosts about one-tenth of the world's offshore market as compared to 3 per cent in 1977. In the following section, we shall look briefly at two of the most popular offshore financial centres in the world, the Eurocurrency Market in Europe and the Asian Dollar Market in Singapore.

TABLE 1. INTERNATIONAL OFFSHORE CURRENCY MARKETS  
(in gross terms)

	1973	1974	1975	1976	1977
Total size (in US\$ billion)	318	384	459	560	614*
Distribution:					
I EUROPE	78.9	76.7	75.7	72.7	72.4
1. UK	40.2	41.2	38.9	36.0	35.7
2. Benelux	9.1	9.9	10.2	10.6	10.8
3. France	10.5	10.3	10.4	10.4	10.3
4. Federal Republic of Germany	2.6	2.7	2.8	3.1	2.7
5. Italy	8.9	4.2	4.1	3.2	3.1
6. Netherland	3.5	4.0	4.5	4.7	4.7
7. Sweden	.6	.6	.7	.6	.6
8. Switzerland	3.6	3.8	4.3	4.1	4.2
II OTHERS					
1. Bahamas & Cayman	8.3	9.2	10.9	13.0	13.4
2. Canada	3.9	3.6	3.0	3.1	3.0
3. Tokyo	5.4	5.4	4.4	4.8	3.1
4. Singapore	2.0	2.7	2.7	3.1	3.1
5. Hong Kong	.8	1.2	1.4	1.5	1.7
6. Panama	.7	1.3	1.4	1.4	1.3
7. Bahrain	.0	.0	.4	1.3	2.0

\* As of September 1977.

SOURCE: Alvin T.T. Hearn and Loh S. Wah, "The Prospects of The Asian Dollar Market", *Singapore Banking and Finance* (Singapore: Institute of Banking and Finance, 1979), p. 168.

## **The Eurocurrency Market**

### *Structure*

The Eurocurrency Market, as discussed earlier, came into existence in the late 1950s. Today, it hosts about two-thirds of the world's offshore financial market. About half of the Eurocurrency Market's activities take place in London. There are more than 400 banks with offshore banking licences in this city, more than twice the number of offshore banks in Hong Kong and about three times those with ACU licences in Singapore.

The largest portion (70-80 per cent) of the Eurocurrency Market is in Eurodollar, that is, transactions denominated in U.S. dollar. The dominance of the U.S. dollar is partly due to its role as a transaction currency, and partly because a substantial proportion of the Eurocurrency deposits is made up of claims on branches of U.S. banks in Europe by their headquarters in the United States. The greater part of Eurocurrency transactions are short-term. In recent years, some Eurobanks are reported to have been involved in medium-term lending but this part of the market has yet to become significant.

Typical Eurocurrency transactions are large and most are inter-bank. The latter, coupled with the fact that not all foreign exchange banks are Eurobanks, created considerable difficulties in finding an appropriate and realistic measure of operations. Because of its size, the London Interbank Offer Rate (LIBOR) is the key rate to which all offshore financial centres align their rates. LIBOR has in turn been closely linked with the U.S. post-Regulation Q rates.

The Eurocurrency Market performs a wide range of useful functions, often more efficiently than the domestic banking system. It provides the world with short- and medium-term investment facilities, forward market and arbitraging facilities, quick liquidity loans often sought by banks including the central banks of many countries, and trade finance.

Its non-bank customers are mostly non-residents. For monetary management purposes, participation by local residents is deliberately restrained by way of exchange control and other regulations. The Eurocurrency activities are freed from any regulations applicable to the domestic market — they are not subject to reserve requirements, income tax, exchange control, stamp duty and other regulations applied to domestic banking activities.

### *Development*

The Eurocurrency Market came into existence mainly to circumvent restrictive regulations imposed by the United Kingdom and later, the U.S.

governments. Among the important factors contributing to the development of the Eurocurrency Market were: a) the termination by the U.K. government in 1957 (as part of an attempt to avoid speculative runs on the sterling) of the use of sterling as a means of settlement in trade with non-sterling countries, which was accompanied by the curtailment of sterling credits to non-residents even within the sterling area; b) the intervention by the U.K. government in banks' portfolio concentration, that is, prohibition of holdings of more than 5 per cent of a bank's assets by any single company; and c) the introduction of the Interest Equalization Tax (IET), and Regulation Q by the U.S. government. IET, introduced in the early 1960s, made holdings of foreign (non-U.S.) securities by U.S. residents unattractive and thus encouraged residents to invest in short-term deposits, an area in which Eurobanks had a tremendous edge over U.S. banks, as most Eurobanks were willing to pay interest even on demand deposits — a facility rarely available with banks in the United States. Regulation Q prevented U.S. banks from paying competitive rates on deposits. It prohibited banks from paying interest on demand deposits and put ceilings on fixed deposit rates. The result was an exodus of funds to Europe which gave a tremendous boost to the Eurocurrency Market.

Other factors also played their parts. The phenomenal growth of the Eurocurrency in the early years would not have been possible had there not been a demand for such services. For example, the selling of gold by the Russian Central Bank in the London bullion market throughout the period 1957-65 for settling trade with the West had created a large demand for dollar deposits in Western Europe as the Soviet bankers preferred to keep the proceeds with banks in Europe in foreign currencies temporarily until payments were due. Countries of Eastern Europe were also transferring their dollar accounts to Europe partly to avoid possible attachment of their account by U.S. claimants, and partly to establish lines of credit with European countries.

On the other hand, Europe (London, in particular) also had its pulls. Firstly, because of tight money policies, London banks were in need of funds. As mentioned earlier, they were willing to pay interest on demand deposits in sterling, and even more so on deposits in foreign currencies since such liabilities were exempt from reserve requirements. Secondly, London had long experience in international banking, a good infrastructure, a wide range of financial and supporting services, and most important of all, a stable economy and political climate. The Bank of England was also more liberal than most monetary authorities in its approach to international business.

## Asian Dollar Market

### *Structure*

As mentioned earlier, the Asian Dollar Market (ADM) hosts about one-tenth of the world's offshore currency market activities.

The market is not a banking system of its own as many observers appear to understand it, but merely a set of accounting units. Banks and non-bank financial institutions (NBFIs) that are granted ACU licences are allowed to set up a separate accounting for all transactions involving currencies other than the Singapore dollar.

Currently, there are 140 banks and NBFIs with ACU licences in Singapore. Of these, 22 are full banks, 12 are restricted banks, 47 are offshore banks, and the rest are merchant banks and investment companies.<sup>4</sup> However, a large proportion of the market activities is in the hands of full banks.

Like the Eurodollar Market, the ADM has also diversified its operations into several currencies. However, by far the largest portion of transactions is in U.S. dollars. About 90 per cent of ACU transactions have been denominated in this currency throughout the period. The second most dominant currency, but far behind, is the Deutschmark (DM) which constituted slightly less than 5 per cent in 1980.

The dominance of the U.S. dollar reflects its role as a vehicle currency in the Southeast Asian region. U.S. banks have also established a wide network of branches here. Forty-six per cent of the loans syndicated in the region are organized by U.S. banks.

The Asian Dollar Market offers fairly standard Eurocurrency services. On loans, they range from two-day call to medium-term rollover. The rates are generally fixed for short-term loans, but floating for those on longer term.

The types of deposit offered are also fairly typical of other offshore markets. Standard terms of maturity are sight, two to seven days notice, one month, three months, six months, and one year. However, unlike the Eurodollar Market, the average size of ACU deposits can be quite small. Some banks in Singapore accept deposits as small as US\$5,000. ACU banks are also allowed to offer conventional demand deposits.

In 1971, the ADM expanded into bonds, and in 1977 into fixed and floating rate certificates of deposits (CD and FRCD). Since their introduction, there have been fifty-two issues of foreign-currency-denominated bonds totalling S\$1,600 million in value. Most of the issues have been in U.S. dollars, while the rest have been in DM and other currencies, including SDRs (special drawing rights). The majority of the issues have been loaned to borrowers from the Asia Pacific region.

The first FRCD was issued by a Japanese bank (Dai-ichi Kangyo) with the assistance of the Monetary Authority of Singapore (MAS). Since then, there have been some ninety issues totalling US\$2 billion. All but fifteen of the issues have been organized by Japanese banks. Most carried terms of maturity of less than three years, the shortest being a one-and-a-half year issue by the Mitsubishi Bank. Most of those with a three-year maturity term carried rates of one percentage point above SIBOR, and most of those with a five-year maturity term had rates of two or three percentage points above SIBOR. Some issues, however, had rather delicately structured rates, such as 0.25 per cent above SIBOR for the first six months, 0.125 per cent above SIBOR for the following six months, and SIBOR for the remaining period.

No data have been published by the MAS on the geographical distribution of ACU business, but data supplied by them to the author suggest that Asia has been a net user of funds while Europe has consistently been the net supplier. Since 1974, the Middle East has also become a net supplier to the ACU. Claims from Asian countries against ACU banks declined from about 60 per cent in 1970 to about 52 per cent in 1980, but loans to the region have been consistently in excess of 70 per cent of the total assets of the market. Most of the loans went to the less developed countries of East and Southeast Asia, such as Indonesia, Malaysia, Philippines, Korea, and Taiwan.

Like the Eurodollar Market, most ACU transactions were inter-bank with standard maturity terms of three months or less. During the first three years of operation, however, most funds were from non-bank sources, presumably multinational corporations, governments, and perhaps individuals associated with the increased expenditure by the United States in the Indochina war.

Although the published statistics suggest that, with the exception of 1970, the market has consistently been a net borrower from domestic banks (Table 2), the fact that the MAS holds some official reserves with ACU suggests otherwise. Bank balance sheets show that by the end of 1980 the MAS had deposited nearly US\$1 billion (about 8 per cent of Singapore's international reserves) with the ACU, suggesting that domestic banks borrowed about US\$500 million from the market.

### *Development*

The Asian Currency Unit came into existence in 1968 when the Monetary Authority of Singapore first permitted banks to accept deposits and extend loans in foreign currencies. A number of factors contributed to the development of the market. To begin with, the Singapore Government had always wanted to develop the city-state into a regional financial



TABLE 2. ACU: INTER-BANK FUNDS, 1970-83  
(in million US\$)

Year	With Banks In Singapore			With Banks Outside Singapore				Net Total
	Loans	Deposits	Net	Loans	Deposits	Net (+ lender - borrower)	Inter-ACU Loans/Deposits	
1970	13	5	7	300	78	221	56	236
1971	38	56	-17	699	642	57	112	39
1972	99	145	-45	1,628	1,801	-173	603	-219
1973	261	405	-144	2,988	3,143	-155	1,700	-299
1974	223	675	-452	5,092	5,711	-619	2,144	-1,071
1975	270	584	-313	6,286	7,337	-1,051	2,372	-1,364
1976	414	799	-384	9,243	11,313	-2,069	2,954	-2,454
1977	573	1,382	-809	11,598	13,887	-2,288	3,080	-3,097
1978	866	1,442	-575	15,244	16,825	-1,581	3,719	-2,157
1979	1,100	1,881	-781	20,994	21,543	-549	5,999	-1,330
1980	1,084	1,304	-219	29,512	29,620	-107	9,955	-327
1981	1,495	1,817	-243	45,155	49,025	-3,870	15,522	-4,193
1982	1,738	1,496	-241	48,612	58,500	-9,888	19,213	-10,130
1983 I	1,742	1,433	-309	48,220	-58,651	-10,431	20,299	-10,740

SOURCE: Monetary Authority of Singapore (MAS), *Quarterly Bulletin*, various issues; and *Monthly Statistical Bulletin*, various issues.