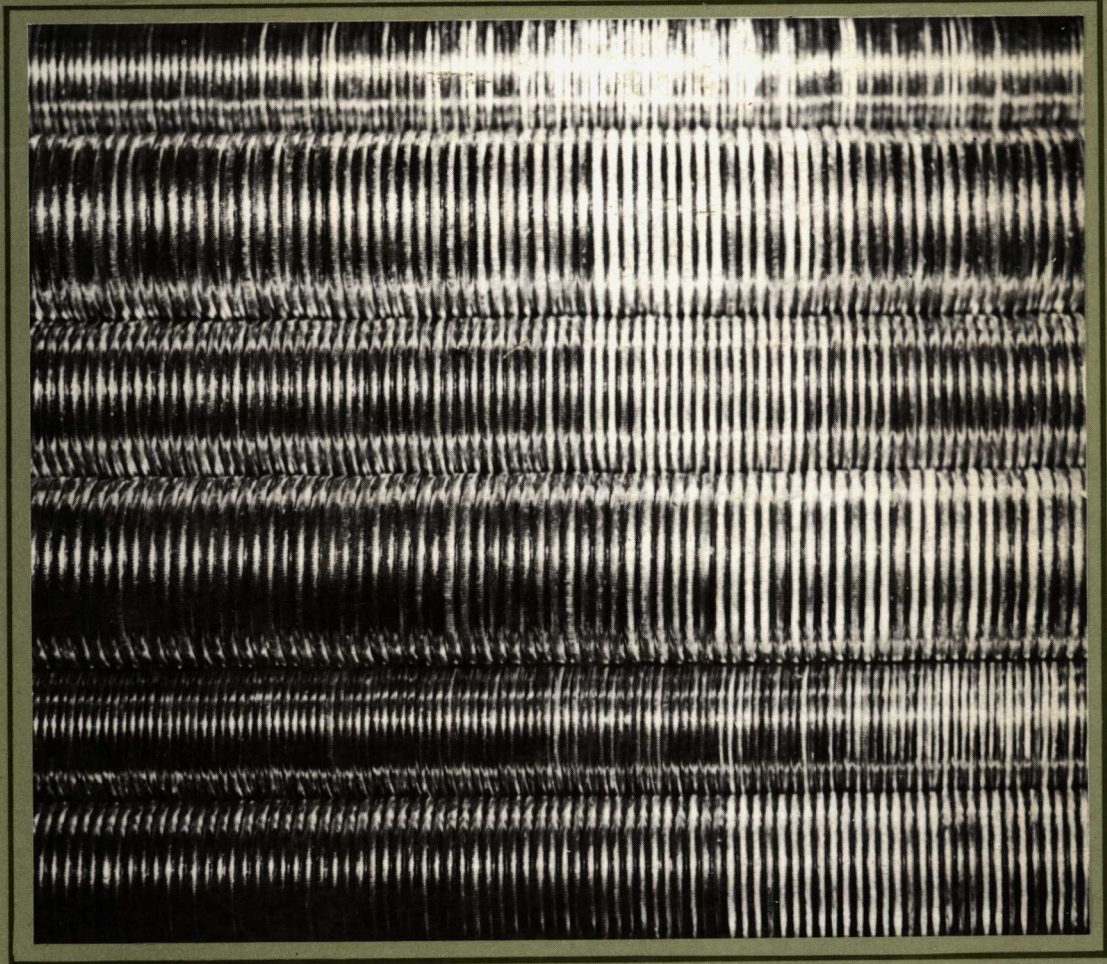


FINANCIAL INSTITUTIONS AND POLICIES IN INDONESIA

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FINANCIAL INSTITUTIONS AND POLICIES IN INDONESIA

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

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ISBN 9971-902-60-5 (Case)

ISBN 9971-902-65-6 (Limp)

Typeset by Richard Clay (S.E. Asia) Pte. Ltd.

Printed by the Singapore National Printers (Pte) Ltd.

“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*

* 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.

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.

ACKNOWLEDGEMENTS

This study could not have been completed without the generous assistance of my teachers and colleagues. I am particularly indebted to my dissertation committee. Professors Benjamin J. Cohen and David O. Dapice read the entire manuscript and offered valuable suggestions concerning substance as well as style and language. The latter, as a teacher and friend, has shaped my understanding of how the Indonesian economy works. Professor Gilbert DeBartolo has been helpful in building and testing the model. Dr Malcolm Gillis of Harvard University commented on the earlier version of the model.

My research in Jakarta (October–November 1980) was assisted by Dr Arifin M. Siregar, Director of the Bank Indonesia; Dr Hans Roden, the IMF resident representative; Drs H. Omar Abdalla, President Director of PT Bank Bumi Daya, who also introduced me to the commercial banking community; Professor Ralph E. Beals, Economic Advisor, Harvard Institute for International Development; and my many colleagues at the Bank Indonesia and the Ministry of Finance.

AID and later MUCIA-AID, through Fakultas Ekonomi UI, provided me with a scholarship during my stay in the United States. The Ford Foundation granted airfares and health insurance for my family, as well as some costs to conduct my research in Indonesia. PT Bank Ekonomi, under the stewardship of its Chairman of the Board/Minister for Co-operatives, General Bustanil Arifin S.H., and its President Director, Drs Abdulgani D.S., furnished supplemental research costs. The Department of Economics and the Tufts Computer Center gave generous computer time.

Revision of my dissertation in its present form would not have been possible without an invitation from Professor Kernial S. Sandhu, Director of the Institute of Southeast Asian Studies (ISEAS) in Singapore, to visit the Institute for a period of two weeks in January 1983. During my stay, ISEAS provided me with accommodation and a living allowance as well as office space in beautiful surroundings and a pleasant working atmosphere.

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.

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AN OVERVIEW OF THE INDONESIAN ECONOMY, 1968-79

BACKGROUND

When the present regime, labelled as the "New Order", came to power in 1966, it inherited a virtually bankrupt nation with an economy near collapse. Production and trade were stagnant, economic infrastructure in disrepair, public administration had deteriorated, and foreign debts were mounting. This was partly caused by economic mismanagement, such as the continuing monetary expansion to finance budget deficits; and partly by other factors, such as supply shocks, natural events, political instability, and the detrimental effects of unfavourable world market conditions. The economy had been suffering from accelerating inflation since the early 1960s, culminating in an increase, measured in the Jakarta cost-of-living index, of over 600% in 1966.

Inflation can be analysed as a purely economic problem, but to cure it requires a strong and stable government that will legislate and implement drastic measures and often make unpopular decisions. For the economy of Indonesia in 1966, it was also important to gain support from the international community in the form of postponements of international debt repayment, new economic aid, and technical assistance throughout the stabilization period.

The present government, headed by President Suharto, a retired army general, came to power in a political upheaval caused by an abortive coup attempt by the communists on 30 September 1965. Under Suharto's leadership the Army, the moderates, and the religious groups suppressed without any outside help what was then the largest communist party outside the communist bloc. At the same time, the ultra-nationalist and isolationist group also became quiescent because of their long political coalition with the leftists. The power of the New Order government was fully consolidated after the retirement of the late President Sukarno in 1966. A period of relative political tranquility began in which the new government started to establish its legitimacy. Since then political stability has never been seriously threatened.¹

With both its internal and external policies, the new regime has made a complete turnabout compared to the direction of its predecessor. The previous government had taken an anti-Western stance in its foreign policy, rejected Western aid, and withdrawn from the IMF, World Bank, U.N., and other international organizations. Its internal policies included nationalization of virtually all foreign business, extensive price control, deliberalization, and reckless spending on projects conceived in pursuit of national prestige

rather than sound economic development. In short, politics came first and economics came later.

The New Order, on the other hand, is a coalition of groups, using Higgins' label, "who attach higher priority to economic and social development of the country, who feel that this development must follow Western lines in large measure, and who are willing to cooperate with the West, at least to the extent of seeking technical and capital assistance from the West, in order to achieve this goal".²

As soon as it had consolidated its power in 1966, the new government reorganized the economic system, gradually moving it from *étatisme* to market mechanism. The new order re-established contact with the West and rejoined the IMF, World Bank, and other international organizations.³ In September of that year a multilateral meeting was held in Tokyo with Indonesia's Western creditors, later known as the Inter-Governmental Group on Indonesia (IGGI), to discuss its need for new aid and rescheduling of old external debts. In October of the same year, Indonesia launched its stabilization and rehabilitation programme. The programme was designed by a group of U.S.-trained economists who taught economics at the University of Indonesia. Early in 1967 the IMF opened a permanent resident representative office in Jakarta to advise the Indonesians on economic policy.

Some of the important elements of the stabilization programme were retained throughout the entire period of this study. In its first five-year economic development plan, 1 April 1969 - 31 March 1974, the government set as its objectives the pursuit of both economic growth and economic stabilization. Since the beginning of the second plan (1974-79), pursuit of economic equality has been added as a third objective of economic development efforts. The aim of this chapter is to summarize the characteristics of the Indonesian economy and its development throughout this period. The inflation and stabilization programme is discussed in the next section. Budgetary trends and policies are presented in the second section. The balance of payments development is presented in the third section and a general overview of income and its structural change are discussed in the last section.

INFLATION AND STABILIZATION

The Course and Causes of Inflation and Efforts to Control It

In Table 1.1, data are presented on selected economic indicators for the period 1966-79. The table brings out the marked variation in the course and causes of inflation occurring during this period. Four phases may be distinguished:

- pre-1967 : Hyperinflation due to very large budget deficits financed by bank credit. Velocity peaked in 1966.⁴
- 1967-72 : Stabilization and rehabilitation period; inflation rate and velocity declined slowly at first and rapidly after 1968. After 1968, the rate of growth of money supply was higher than the inflation rate and the economy grew at a respectable rate.
- 1972-74 : Resurgence of inflation. Velocity continued to decline at first and then increased in 1974. This period was marked by a shortfall in the rice crop accompanied by increases in the price of non-oil exports in 1972, increases in the inflow of private borrowing, and quadrupling of new oil receipts in 1973-74.