Edited by
José M. Fanelli and Rohinton Medhora

FINANCIAL REFORM IN DEVELOPING COUNTRIES

IDRC

CANADA

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To my wife

José M. Fanelli

To my parents

Rohinton Medhora

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9.1 INTRODUCTION

Two recent changes in the management of the Indonesian and Malaysian economies have altered the economic environment in which their central banks operate and the instruments used to control monetary aggregates. First, adjustment programmes adopted in these countries since the early 1980s have moved the management of their economies to a more market-based system. In general, these adjustment programmes have changed each country's development strategy from a policy of state-led, import-substituting industrialization (ISI) to one of private-sector-led export orientation (EO). Second, both countries have improved the infrastructure of their financial markets by adopting the CAMEL (capital adequacy, asset quality, management, earnings and liquidity) system, under which capital adequacy, asset quality and liquidity are the key variables. On capital adequacy, both countries use the risk-based-capital guidelines for all banks as suggested by the Basle Supervisors' Committee in 1987. The guidelines bring a full range of on- and off-balance-sheet assets into the risk-based system. A harmonized risk-weighting system has been developed to assess the different degrees of risk associated with each category of assets.

The impetus for the reforms in these two countries was the world economic recession of 1981–3, which depressed the prices of their export commodities, particularly petroleum. The sharp decline in export earnings and government revenue forced them to re-evaluate their development strategy, including fiscal, trade, financial, investment and labour policies. The financial liberalization, which included removal or relaxation of financial repression, capital controls and the policy to lower barriers to entry in financial industry, has increased competition between banks and non-bank intermediaries.

The subsequent rise in exports and domestic interest rates, and improvements in financial services, have improved domestic savings mobilization and resource allocation. The reforms, however, have diminished the autonomy of the two countries in directing monetary policy for attaining domestic policy targets. By definition, internal deregulation shifts the interest rate decision to the market. External deregulation, which relaxes capital controls, on the other hand, increases capital mobility and makes it sensitive to interest rate differential and exchange rate expectations. Closer integration of the domestic market for financial assets, goods, services and labour with international markets, therefore, makes the domestic economy more sensitive to foreign economic events and policies.

The purpose of this chapter is to contrast the gradual process of financial sector reform in Malaysia with the rapid one in Indonesia since the early 1980s. This study focuses mainly on reform in the banking sector, because it is the core of the financial system and the main channel for the private sector's short-term capital inflows into these countries. Along with deregulation, the authorities in these countries have strengthened rules and regulations, stepped-up prudential measures and developed money markets.

The rest of this chapter is divided into seven sections. Section 9.2 discusses the structure of the financial sector in each country and the influence of the central banks on it. Section 9.3 analyses the leadership and sequence of the financial sector reform. Section 9.4 summarizes the contents of the reforms. Section 9.5 investigates programmes to restructure the distressed banking industry. Section 9.6 describes policies to develop money markets. Section 9.7 analyses the impacts of the reforms on monetary aggregates. Concluding remarks are provided in the last section.

9.2 THE STRUCTURE OF FINANCIAL INDUSTRY

The economic environment and market infrastructure have been more conducive to growth of the financial system in Malaysia than they have in Indonesia. First of all, political and social systems in Malaysia have been relatively stable. This country also has a well-established market infrastructure, particularly the legal and accounting systems. In contrast, from the beginning of World War II to the first half of the 1960s, Indonesia had been constantly in political turmoil, with successive civil wars, hyperinflation, monetary purges, nationalization of private assets and economic stagnation. Moreover, as shown in Table 9.1, Malaysia has higher income per capita (1993: \$3140) than Indonesia (1993: \$740). In the World Bank's classification Malaysia belongs to the upper-middle-income group and Indonesia is in the lower-middle-income group.

The financial repression during the oil boom period in the early 1970s hindered development of the financial sector in these countries. The financial repression was a part of the policy they had adopted to channel the oil windfall for pursuing economic nationalism and to redress racial economic imbalances. As a result, the oil money was used to finance import substitution industrial policies and to provide credit at subsidized interest rates to target groups and economic sectors. As will be discussed in later sections, the abuse of the programmes for patrimonialism and outright corruption has been more profound in Indonesia than in Malaysia.

When Malaysia and Indonesia started their broad-based economic reform, their economies were relatively stable. With an annual average inflation rate of 2.2 per cent in the 1980s, Malaysia belongs to a group of countries with a low inflation rate. In contrast, Indonesia belongs to the group of countries with a moderate inflation rate, at 8.5 per cent per annum (Table 9.1). The movement toward a private-sector-oriented economy has reduced the share of government expenditure in both countries. Between 1985 and 1993, public spending, measured as a percentage of GDP, was reduced from 31.4 to 25.4 per cent in Malaysia and from 23.5 to 16.3 per cent in Indonesia. During the same period, the fiscal deficit was reduced from 5.7 per cent to –0.2 per cent in Malaysia and from 3.7 per cent to 0.4 per cent in Indonesia.

The fiscal deficit has not been the prime source of credit expansion in these countries. In the case of Indonesia, the deficit has been financed by external borrowings, particularly from official sources at concessionary terms. Because it has already been graduated from being a recipient of official development assistance, Malaysia finances its budget deficit primarily by selling government bonds in the domestic market. To ease the rising burden of external debt service, both countries have adopted a policy to make substantial repayments of public external debt by using the rising revenues from privatization of state-owned enterprises. These two countries have also reformed their tax systems in order to raise revenue from domestic taxation and thereby reduce the need for external financing. The decline in budget financing from external borrowings has reduced the sensitivity of their governments budget expenditures to exchange rate and interest rate risks. Real interest rates in Indonesia were negative until the June 1983 liberalization, whereas in Malaysia they have always been positive.

Tables 9.2 and 9.3 indicate that, in terms of total assets and number of institutions and their branch offices, the core of the financial sector in both Malaysia and Indonesia is still the banking system. Other financial institutions, such as those in the capital market, leasing companies, insurance

Table 9.1 Malaysia and Indonesia: key macroeconomic indicators, 1970–93

	Malaysia		Indonesia	
Economic indicators	*1970–80*	*1980–93*	*1970–80*	*1980–93*
1. Average annual rate of inflation (%)	7.3	2.2	21.5	8.5
2. Average annual growth rate of GDP (in per cent)	7.9	6.2	7.2	5.8
3. Income per capita (USD, 1993)	*1970*	*1993*	*1970*	*1993*
Gross national product		3 140		750
PPP estimate		8 400		5 150
As percentage of GDP	*1985*	*1993*	*1985*	*1993*
4. Total expenditures	32.9	25.4	23.5	16.3
5. Fiscal deficit	5.7	–0.2	3.7	0.4
6. Domestic Savings, Capital Formation and Resource Gap (as per cent of GDP):	*1975*	*1994*	*1975*	*1994*
Gross domestic savings	23.8	35.6	21.0	38.7
Gross capital formation	23.4	37.2	20.3	35.5
Resource gap	–0.5	1.6	–0.7	–3.2
7. Nominal interest rates of banks (annual average, %):	*1980*	*1993*	*1980*	*1993*
Deposit rates	6.2	7.2	6.0	20.4
Lending rates	7.8	8.1	...	20.2

Sources: World Bank, *World Development Report 1995*; EDRC, Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 1995*, vol. XXVI.

firms, unit trusts and building societies are fast-growing segments of the financial system. As of December 1994, the banking system of Malaysia consisted of Bank Negara Malaysia (the central bank); 37 commercial banks; Bank Islam Malaysia Berhad; 45 finance companies; 12 merchant banks; 7 development finance companies; 7 discount houses; and 8 money and foreign exchange brokers that are regulated and supervised by Bank Negara Malaysia. Of the commercial banks 21 are domestically owned and the remaining 16 are foreign-owned.

To comply with the Banking and Financial Institutions Act of 1989, the 14 branch offices of foreign banks were locally incorporated in 1994. Seven of the domestic commercial banks belong to tier I (well-managed with strong financial standing) institutions and are authorized to deal with foreign exchange transactions. The commercial banks account for about 85 per cent of the total assets of the banking system. In terms of total asset and number of branch offices, the state-controlled Bank Bumi Putra Malaysia Berhad and Malayan Banking Berhad are the lead banks. Although Malaysia has no official state-owned bank, state-owned companies do hold major shares of banks – for example, Petronas – the state-owned oil company – is the major shareholder of Bank Bumi Putra Malaysia.

The banking system in Indonesia, as of March 1994, consisted of Bank Indonesia, which serves as the central bank; 7 state-owned commercial banks; 163 national private commercial banks; 39 joint venture banks; 27 commercial banks owned by provincial governments; 1 Islamic bank (Bank Muamalat); 8757 rural banks; 13 merchant banks; and a number of money and foreign exchange brokers all of which are regulated and supervised by Bank Indonesia. Of the commercial banks 67 were licensed to deal with foreign exchange transactions.

Consisting of development finance corporations and investment finance corporations, NBFIs – non-bank financial institutions – operating in both Malaysia and Indonesia are linked to commercial banks. In theory, the first type of NBFI is similar to a development bank, because its activity is focused on medium- and long-term financing and equity participation. The activities of the second type of NBFI are similar to those of a merchant bank, acting as intermediary and underwriter of financial papers and providing financing for medium- and long-term investment. However, because of the narrowness and shallowness of domestic money and capital markets, NBFIs in these countries provide short-term business finance and loans for the purchase of consumer durable goods such as motor vehicles.

The largest institution in the group of NBFIs in Malaysia is the state-controlled Employees' Provident Fund (EPF), which mobilizes contractual savings in the form of provident and pension fund contributions. At the end of 1990, this fund accounted for over 22 per cent of the total assets of the financial system. The operations of NBFIs and their impacts on money supply will be discussed further in Section 9.7.

There are four financial ratios that measure roughly the size of financial system relative to the size of the total economy, as presented at the bottom of Table 9.3. They, respectively, measure the percentage share of narrow money (M1), broad money (M2), total assets of all types of financial institutions (TAFI), and equity shares to the gross domestic product (GDP). The first two ratios are standardized across countries because of standardized statistics compiled by the IMF. However, they only cover the monetary liabilities of the central bank and deposit money banks (DMBs).[1] M1 includes currency, coins, demand or checking deposits and other current deposits that are highly liquid.[2] M2 is equal to M1 plus the less liquid savings and time deposits, money market mutual fund shares available for individuals, overnight repurchases agreements, and foreign exchange deposits at DMBs that are not directly utilized as a means of payments. Even though they are denominated in foreign currency, the characteristics of foreign currency deposits are similar to those of other components of quasi-money.

Authorized DMBs in Indonesia and Malaysia are allowed both to receive deposits from and to lend to residents in foreign currency. Mainly because of economic overheating, the share of dollar deposits – as a percentage of M2 – at DMBs in these countries has increased rapidly since 1991. TAFI provides a rough indicator of growth and structural change of the financial system. However, it also has disadvantages (Cole, 1993), because it excludes the equity and debt securities held by firms and households. Moreover, simply adding total assets of financial institutions involves double counting. Furthermore, financial accounts of some non-bank financial intermediaries are available only for selected years and with much longer time lags as compared with the components of M1 and M2.

The financial ratios are higher in Malaysia than in Indonesia. A large share of TAFI in Indonesia during the past financial repression period was the central bank's assets, because it refinanced most of state-owned banks' credit. The rapid and steady growth of M2 and TAFI since the late 1980s indicates the rapid growth of bank assets following the reforms in 1988 and those of the capital markets in the following years. Within the banking system, the shares of state-owned banks and merchant banks dropped substantially, while the shares of private domestic banks rose dramatically. This will be discussed more thoroughly in the next subsection. Despite the rapid growth of their assets, the role of the non-bank financial institutions

Table 9.2 Indonesia and Malaysia: structure of the financial sectors, 1988 and 1994[a]

	Indonesia				Malaysia			
	Number		Share in assets		Number		Share in assets	
	1988	*1994*	*1988*	*1994*	*1987*	*1994*	*1987*	*1994*
Central bank	1	1	36.8	21	1	1	11.8	14.8
Deposit money banks	111	238	56.9	79	38	37	42.1	38.6
State-owned commercial banks	5	5	34.5	30.9	0	0		
Private banks	63	162	13.1	33.6	38	37		
Private forex banks	12	51	8.8	28.9	23	21		
Private non-forex banks	51	111	4.3	4.7	15	16		
Foreign and joint venture banks	11	39	2.8	6.5	16	14[b]		
Development banks	29	29	4.4	6.7	7[c]	7[c]	2.3	1.5
Saving banks	3	3	2.1	1.3	1	1	3.7	2.5

Table 9.2 (continued)

	Indonesia				*Malaysia*			
	Number		*Share in assets*		*Number*		*Share in assets*	
	1988	*1994*	*1988*	*1994*	*1987*	*1994*	*1987*	*1994*
Non-bank financial institutions	13	0	2.7	n.a.	12	12	4.9[d]	5.2[d]
Insurance companies	106	n.a.	1.6	n.a.			20.8[e]	18.8[e]
Leasing/finance companies	83	n.a.	1.5	n.a.	47	40	10.4	11.7
Other credit institutions	5 783	n.a.	0.6	n.a.	2104[f]	n.a.	4.0	6.9
Total			100.0	100.0			100.0	100.0

n.a. = not available.

[a] Except data for 1988 for Malaysia; replaced by data for 1987.
[b] Two foreign banks, namely United Overseas Bank and Security Pacific Asian Bank, sold their Malaysian branch operations to Malaysia Interest in 1994.
[c] Consist of Malaysia Industrial Development Finance (MIDF), Borneo Development Corporation (MDC), Sabah Development Bank (SDB), Sabah Credit Corporation (SCC), Development Bank of Malaysia (DBM), Industrial Bank of Malaysia, and Agricultural Bank.
[d] Include assets of merchant banks, discount houses, and credit guarantee corporations.
[e] Include provident and pension funds.
[f] Cooperatives societies.

Sources: Bank Negara Malaysia (1989); Bank Negara Malaysia (1994); Bank Indonesia, *Indonesian Financial Statistics and Annual Report*, various issues.

in Indonesia is still relatively small and is only beginning to provide a competitive challenge for the banks.

The domination of the financial sector by commercial banks is mirrored in a heavy reliance of business firms' heavy reliance on debt financing in these countries. This has adverse effects at the microeconomic level, because it has led to an unbalanced funding structure among firms in the real sector.

High debt-to-equity ratios present few problems as long as the concerned firms continue to grow. A highly leveraged financial system, however, simultaneously renders enterprises and their banks vulnerable to internal and external shocks. Thus, the rise in interest rates together with major currency realignments (such as in the second half of 1980s and early 1995) meant that heavy reliance on debt strained the cash flows of companies. On the other hand, many of these companies are becoming less profitable because of reductions in economic rents, as levels of protection have been much reduced, reflecting new government policies aimed at economic restructuring.

TAFI, the fourth indicator, focuses on the stock market, which has become an important source for raising funds to finance private investment following the financial sector reforms in Malaysia and Indonesia. The Kuala Lumpur Stock Exchange (KLSE) was separated from the Stock Exchange of Singapore (SES) and established as an independent exchange effective from 1 January 1990. The Jakarta Stock Exchange (JSE) was established in August 1977, and this was followed by the establishment of the Surabaya Stock Exchange (SSE) on 30 March 1989[3] and the Parallel Bourse in the same year. Despite divestment schedules for foreign investment and generous tax incentives to sell shares, the three stock exchanges in Indonesia were relatively undeveloped before 1989. On the supply side, there was no need for domestic companies to raise capital by selling securities in the capital markets, because they could easily get credit with low interest rates and low risks from the state-owned banks. The state-owned enterprises could obtain zero interest capital from the state budget. On the demand side, domestic securities were unattractive, because PT Danareksa set their gross yields at the equivalent to interest rates on one-year time deposits at state-owned commercial banks.[4] As a result, there were only 24 companies (mostly foreign companies to meet the mandated divestment schedules) selling shares and 9 floated bonds (mostly state-owned firms on promotional basis) in these markets in 1988.

There are several factors that made the KLSE much more matured than the JSE. First, government control in both bank credit and the capital market was not seen as distortive in Malaysia like it was in Indonesia.

Table 9.3 Malaysia and Indonesia: financial ratios 1980–90 (percentage of GDP)

	Malaysia				*Indonesia*			
	1980	*1985*	*1990*	*1995*	*1980*	*1985*	*1990*	*1995*
M1	15.0	16.9	21.9	35.1	4.3	7.0	12.2	12.9
M2	42.3	58.7	66.2	103.1	6.7	16.0	43.3	53.5
TAFI						0.3[a]	0.52[a]	0.78[a]
Market capitalisation		52.0	113.7	341.9[b]		0.1	7.6	22.7[b]

[a] TAFI for Indonesia are for the years of 1982, 1988 and 1991.
[b] for the year of 1993.

Sources: ADB (1995) *Asian Development Outlook 1995 and 1996*, Table 3.1, p. 199; IFC (1995); IMF (1995).

Second, privatization of the state-owned enterprises – as a mechanism for domestic savings mobilization for long-term capital investment – was started earlier, and was more advanced, in Malaysia. To reduce the burden of external debt service, these countries have recently used the proceeds from the selling of equity of state-owned enterprises for early repayment of part of their external debts. In Indonesia, foreign investors are permitted to purchase up to 49 per cent of shares in listed companies. Acquisition of 15 per cent or more of the voting power (equity interests) by foreigners in the aggregate of 30 per cent or more of the voting power of a Malaysian company or business requires prior approval from the authorities. In December 1994, there were 478 companies listed in Kuala Lumpur with the ratio of stock market capitalization to DP at 274.54 per cent, as compared with 261 companies and market capitalization at 27.52 per cent of GDP in Indonesia. The size of market capitalization of the KLSE (at $278 billion) ranked it among the 15 largest markets in the world and more than 3.5 times than that of the JSE.

The rise in financial deepening indicates not only positive developments, but also the existence of potential problems. The rising ratios of domestic liquid assets to foreign assets, and the increase in the share of domestic assets held by foreign private investors, have made management of monetary policy more difficult and have increased domestic economies' susceptibility to external shocks. Moreover, deposits at state-owned commercial banks are generally perceived by the public as contingent liabilities of the monetary authorities. As a result, a bank run can easily translate into a currency run when the proportion of short-term liabilities to central bank liquid assets is quite high (Calvo, 1994).

9.3 THE LEADERSHIP AND SEQUENCE OF THE REFORMS

The scope and sequencing of banking policy reforms in the 1980s were much wider and faster in Indonesia than the gradual approach in Malaysia. These differences may be linked to a variety of economic and political environments (including the stage of financial development and policies prior to the reforms) and administrative capacity of individual countries. Prior to the reform, the financial repression, which included direct allocative and pricing controls over financial institutions, was more profound in Indonesia. Like in Indonesia, the authorities in Malaysia administered interest rates, set ceilings on bank credit, and imposed guidelines on credit allocation as instruments to pursue the twin national objectives of the eradication of poverty and the restructuring of society. However, Malaysia has used a less rigid, more general and flexible mechanism than Indonesia.

The 'technocrats'[5] have been the driving force for economy-wide liberalization, including financial sector reform in Indonesia. Having been retired and becoming advisors to the government, the 'technocrats' no longer enjoy the executive power of the government. Nevertheless, they are still listened to by both their successors and foreign lenders. Partly owing to a concern about the difficulty to improve its capabilities to regulate and supervise the banking system and other financial institutions, Bank Indonesia has tended to retain more direct controls over the financial system. The Ministry of Finance is the licensing authority for all financial institutions, and Bank Indonesia is given the tasks of regulating and supervising the banking system. In the case of Malaysia, however, the central bank has been the initiator of the financial liberalization, and the Ministry of Finance has played a supporting role (Cole, 1993).

Economic reform cannot be achieved overnight. It takes some time to improve market infrastructure. In addition, the speeds differ at which different sectors of the economy adjust and respond to the deregulation. This raises questions concerning the efficiency and equity of the adjustment program. Thus, the economic literature poses an important question about the order, or sequence, in which to carry out deregulation. Edwards (1989) and McKinnon (1991) introduced the concept of sequencing. They recommend that, first, financial liberalization should be done after trade and fiscal reforms – the former to align domestic prices with international prices and the later to curtail budget deficits. Their second recommendation is that liberalization in the capital account should be made only after the liberalization of the domestic financial market.

Indonesia and Malaysia have adopted a reversed sequence of broad-based economic reform. Since its independence from British rule in 1963, Malaysia has maintained relatively relaxed foreign capital control. Deregulation of the capital account in Indonesia was introduced, along with unification of the exchange rate, in April 1970, though both countries have at times imposed capital control for the sake of stability. Under such an open exchange rate system, in both Malaysia and Indonesia, there was no requirement for the surrender of export proceeds, nor taxes on or subsidies for the purchase or sale of foreign exchange. The system is more liberal in Indonesia, however, because foreign nationals and local citizens are free to open accounts in either domestic or foreign currency in the authorized banks, whereas in Malaysia only non-residents are allowed to open foreign currency deposits at local commercial banks and merchant banks. The seven discount houses in Malaysia are allowed to accept interest-earning deposits from the general public, the banks and non-bank financial institutions. The minimum size and tenure of such deposits in foreign currency are however regulated by the Malaysian authorities. The commercial banks in both countries are free to extend credits in foreign currencies.

It is also interesting to note that the initial response of Malaysia to external shocks in the early 1980s was the complete opposite of that of Indonesia. In the early 1980s, Malaysia continued to expand domestic absorption as the government continued to guarantee massive foreign borrowings, mainly from Japan, to finance a heavy industrialization programme including steel, cement, auto and motorcycle plants set up through public enterprise. The federal budget deficit and current account deficit in Malaysia rose from 7.2 per cent of GNP and 1.2 per cent of GNP, respectively, in 1981, to 18 per cent and 14 per cent in 1982. The policy reversal was introduced in 1985, as the government announced various measures of economic stabilization and adjustment. The stabilization programme included a big cut in government investment spending, the adjustment programme measures to consolidate and rationalize the activities of non-financial state-owned enterprises. The privatization policy was announced in 1983 and the Privatization Master Plan issued in 1991.[6]

In contrast, Indonesia immediately adopted a short-run stabilization program in 1983, by cancelling a number of large, capital-intensive investment projects. To raise government revenues, Indonesia reformed its tax system between 1983 and 1985. As in Malaysia, the deregulation programme in the real sector of the economy was begun only in 1985. But the privatization of the 180 Indonesian state-owned enterprises has been much slower than the comparable process in Malaysia. Part of the problem is that the government has focused its efforts on public listings on both domestic and international stock exchanges. This method may be more transparent and have promoted wider equity ownership, but most state-owned enterprises cannot meet the stringent listing requirements of financial health and performance.

To prevent the reckless overexpansion of credit, which may result in causing overexpansion of credit, rising inflation, widening current account deficits and banking distress, some economic theoreticians (including Corbo and de Melo, 1987; McKinnon, 1991) have suggested a 'proper' course of banking deregulation. This begins with improving the market infrastructure by tightly monitoring and regulating the commercial banks, by means that include temporary credit rationing. The second step is to recapitalize the existing banks and their clientele. Third, during the transition period, the banking industry is closed temporarily to new entrants both domestic and foreign, mainly because any new entrants would not be burdened with low-yield loans, and could easily out-compete the banks that have existed since the pre-reform period.

Malaysia has taken a gradualistic but steady approach to financial sector reform, more or less in line with such a 'proper' sequence and better co-ordinated with the reforms in other sectors of the economy. Malaysia began liberalization of deposit rates in 1971 by allowing commercial banks to set market-determined interest rates for fixed deposits with maturities of more than four years. In January 1992, the authorities lifted the ceilings on rates of commercial bank deposits with maturities of more than one year. The phasing out of the administered interest rate regime was completed on 23 October 1978, when the commercial banks were allowed to set their deposit and loan interest rates. Prior to the fully fledged liberalization of interest rates, Malaysia has had improved financial market infrastructure and developed money markets.

Banking sector policy reform began in Indonesia in June 1983, when Bank Indonesia reduced the scope of its credit programme and liberalized most deposit and lending interest rates. But instruments of indirect monetary management were introduced in April 1984, a year after the reform. A more drastic reform was introduced in October 1988, but prudential rules and regulations to risk-based capital standard were not introduced until February 1991 (Table 9.4). However, the authorities had to lower the prudential standards because many banks, particularly the state-owned ones, were unable to meet them. Such amendments, corrections, extended periods of consolidation and retreats make the liberalization programme less transparent and sometimes confusing.

9.4 CONTENTS OF THE REFORMS

The coverage of financial sector policy reforms has been much wider in Indonesia than in Malaysia. The reforms in Indonesia contain measures that affect market competition, interest rates, the allocation of financial instruments, prudential rules and regulations, money markets and the financial market infrastructure (Table 9.4). In contrast, the reforms in Malaysia have been dealt mainly with the deregulation of interest rates, prudential measures and the market infrastructure (Table 9.5). The reforms that allow new entry in offshore banking, charge card businesses and insurance and reinsurance are in line with both countries' commitments to the interim WTO financial services agreement.

Types of Bank and the Scope of Bank Activities

Both Indonesia and Malaysia have adopted the Anglo-Saxon system, limiting commercial banks' activities to operating the payments system and to extending short-term commercial credit. Non-bank financial institutions (NBFIs) and securities markets are assigned to mobilizing and allocating long-term savings. The October 1988 banking reform in Indonesia removed the traditional functional specialization between different banks and major areas of specialization for state-owned banks. Since, the introduction of this reform, there have been only two types of banks operating in the country – commercial banks and rural ones. Also known as a Bank Perkreditan Rakyat (BPR), a rural bank is a unitary local bank that is not allowed to accept demand deposits. The new prudential safeguards, however, retain the portfolio constraints on banks in bonds and equities.

The status of the existing special-purpose institutions such as development, savings and mortgage banks was converted automatically into that of commercial banks. Each of the 12 non-bank financial institutions (merchant and development banks) was given one full year, starting from December 1991, to make the adjustment to be either a security company or a commercial bank. Each existing 'secondary bank' was given the option either to convert its status into a BPR or else to cease operation. Immediately, the secondary banks all converted into BPRs and all of the NBFIs opted, between January and March 1993, to become fully fledged joint venture commercial banks.

Table 9.4 Indonesia: reform in the banking industry, 1983–95

Policy measures	*Before reform*	*After reform*	*Date*
I. Competitive measures			
(1) Entry of new banks			
(a) Private banks	Moratorium since 1970	Permitted	October 1988
(b) Foreign banks	Moratorium since 1970	Permitted to enter as joint venture	October 1988
(2) Branching power			
(a) Private banks	Restricted[a]	Permitted to sound banks	October 1988
(b) Foreign banks	Restricted to Jakarta	Permitted to seven cities (later Batam)	October 1988
(3) Foreign exchange licence	Restricted[a]	Eligible for sound banks	October 1988
(4) Types of loans			
(a) State banks	Mainly the extended subsidized credit programs, as set and refinanced by Bank Indonesia	The scope and coverage of the subsidized credit Programs reduced	June 1983 27 January 1990
(b) Private banks	Free to set	20% total credit must be extended to small business[b]	October 1988
(c) Foreign banks	Free to set	50% total credit must be extended to export-related activities	October 1988
(5) Types of saving and deposit schemes			
(a) State banks	Set by Bank Indonesia	Free to set	1 June 1983
(b) Private banks	Free to set	Free to set	
(c) Foreign banks	Free to set	Free to set	
(6) Deposits of the public sector	Restricted to state banks	Restricted to state banks	October 1988
(7) Deposits of the state enterprises	Restricted to state banks	Up to 50% with private banks	October 1988
(8) Deposit rates			
(a) State banks	Set by Bank Indonesia	Free to set	1 June 1983
(b) Private banks	Free to set	Free to set	
(c) Foreign banks	Free to set	Free to set	
(9) Loan rates			
(a) State banks	Controlled by Bank Indonesia	Free to set	1 June 1983
(b) Private banks	Free to set	Free to set	
(c) Foreign banks	Free to set	Free to set	
(10) Credit ceilings			
(a) State banks	Set by Bank Indonesia	Eliminated	1 June 1983
(b) Private banks	Set by Bank Indonesia	Eliminated	1 June 1983
(c) Foreign banks	Set by Bank Indonesia	Eliminated	1 June 1983

Table 9.4 *(continued)*

Policy measures	*Before reform*	*After reform*	*Date*
(11) Foreign exchange power (limited to licensed banks)	Subjected to ceilings set by Bank Indonesia	Net open position[c]	November 1989
(12) Reserve requirements	15% of deposits (differentiated between banks)	2% of deposits	October 1988
(13) Entry to new activities			December 1988[d]
(a) Leasing	Not regulated	Subsidiary	
(b) Venture capital	Not regulated	Subsidiary	
(c) Securities trading	Not regulated	Not for own account, not as broker/dealer	
(d) Factoring	Not regulated	Directly	
(e) Consumer finance	Not regulated	Directly	
(f) Credit cards	Not regulated	Directly	
(g) Underwriting shares[e]	—	Prohibited	
(h) Custodian	Not regulated	Approval required for capital market	Otherwise can do as part of
(i) Trustee and guarantor	Not regulated	Approval required for capital market	usual activities
(j) Securities administrative agency	Not regulated	Prohibited	
(k) Investment manager	Not regulated	Subsidiaries	
II. Prudential measures			
(1) Capital Requirements			
(a) General banks			
(i) Private banks	—	Rp 10 billion Rp 50 billion	October 1988 October 1992
(ii) Joint venture banks	—	Rp 50 billion	October 1988
(minimum 15% Indonesian ownership)		Rp 100 billion	October 1992
(b) Bank Perkreditan Rakyat		Rp 50 million	October 1988
(2) Legal lending limits	None	(1) Old credit: (% of bank capital)	29 May 1993
		Individual Group	
		20% 50%	By 29 May 1993
		20% 50%	By December 1995
		20% 50%	By March 1997
		(2) New credit 20% for individual and 20% for group	
(3) Loan to deposit ratio	None	110%	February 1991[b]

Table 9.4 *(continued)*

Policy measures	*Before reform*	*After reform*	*Date*
(4) Capital adequacy ratio	None	(% of risk-weighted assets) 5% by March 1992 7% by March 1993 8% by Dec. 1993[g]	February 1991
(5) Net open position	None	25% of capital	March, 1989
(6) Accounting standard	None		1 January 1993
III. Money market Reintroduced in February 1984, SBI is the most important money market instrument at present. On 1 June 1993 the auction system of SBI changed from 'cut-off rate' (COR) to 'stop-out rate' (SOR). The private sector commercial paper (SBPU) introduced in January 1985. Until now, the government has not floated treasury bonds in domestic market.			
IV. Transparency and accountability of reporting and management			
(1) To improve banking supervision by (a) standardizing accounting and reporting system; (b) requiring commercial bank to submit detailed business plans to the central bank and banning person involved in fraudulent transactions or defaulted on significant loans from becoming shareholders, executives or member of the board of commissioners of banks.			January 1995
(2) Banks are required to (a) submit detailed credit plan to Bank Indonesia and those with uncollectible amounted to 7.5% of total credit or more are required to submit credit recovery plans; (b) standardize internal audit system and (c) adopt information system technology.			March, 1995

[a] Permitted in principle, but economic and social requirements made it prohibited in practice.
[b] Since 29 May, can be channelled through other banks and BPRs.
[c] Overseas borrowing for public sector is subject to ceilings set by TKPLLN (Coordinating Team for Management of Commercial Offshore Loans) since October 1991.
[d] Items (g) to (j) are subject to Ministry of Finance's Decision no. 1548 of 4 December 1990.
[e] Can underwrite bonds and other debt instruments.
[f] Since 29 May 1993 own capital; included in the denominator.
[g] In 29 May 1993 this schedule was extended to December 1994.

Sources: Packages of government regulations (circulars and announcements): Pakto 1988, Pakmar 1988, Pakjan 1990, Pakfeb 1991, Banking Law Number 7, 1992; Banking Regulation, May 29, 1993; Nasution (1983); Cole and Slade (1991).

In contrast, Malaysia retains various types of specialized financial institutions, which include the Industrial Development Bank of Malaysia Berhad (IDBM), the Agricultural Bank of Malaysia (ABM), the Development Bank of Malaysia (DBM) and the Sabah Development Bank. In addition, there are a number of public development statutory agencies that extend finance to individuals and enterprises for investment in commerce, agriculture and industry. These agencies include the Council of Trust for Indigenous People (MARA), the Federal Land Development Authority (FELDA), the Rubber Industry Smallholders' Development Authority (RISDA), various state development corporations, and a number

Table 9.5 Malaysia: reform in the banking industry, 1987–95

Policy measures	*Before reform*	*After reform*	*Date*
I. *Competitive measures*			
(1) Entry of new banks			
(a) Commercial banks			
(i) Domestic banks	Permitted	Permitted	1 October 1989
(ii) Foreign banks	Permitted	By the Banking Act 1973 and the Banking and Financial Institution Act 1969 (BAFIA) the 16 foreign banks were required to be locally incorporated by September 1994	
(b) Specialized banks			
(i) Development banks	Restricted	Restricted	
(ii) Agriculture banks	Restricted	Restricted	
(iii) Industrial banks	Restricted	Restricted	
(iv) Islamic banks	Permitted	Regulated by Islamic Banking Act of 1983	March 1983
(2) Branching power			
(a) Private banks	Permitted to sound banks	Permitted to sound banks	
(b) Foreign banks	Not allowed	Not allowed	1966
(3) Foreign exchange licence	Eligible for sound banks	7 banks are granted to operate in tier I to accept deposit and give loans in foreign currencies	1 December 94
(4) Types of loans			
(a) Special purpose banks	Mainly extended subsidized Credit programs to specific target groups, as set and refinanced by Bank Negara Malaysia		
(b) Commercial banks	Subject to lending guidelines as set and periodically revised by Bank Negara Malaysia		October 1976
(5) Deposits of the public sector (6) Deposits of the state enterprises	Preferably to certain banks, such as Bank Bumi Putra and Malaysian Banking Bhd..	Preferably to certain banks, such as Bank Bumi Putra and Malaysian Banking Bhd.	
(7) Foreign exchange power		Net open position	17 January 1994

Table 9.5 *(continued)*

Policy measures	*Before reform*	*After reform*	*Date*
(8) Reserve Requirements			
(a) Standard	$8\frac{1}{2}\%$	Increased three times to $11\frac{1}{2}\%$ since 1 July 1994	Between January and July 1994
(b) Placement of the ringgit funds of foreign banks in non-interest bearing vostro account at Bank Negara Malaysia	Not required	Required	2 February 1994
(9) Deposit rates	Set by Bank Negara Malaysia	Free to set	23 October 1978
(10) Loan rates	Set by Bank Negara Malaysia	Free to set	23 October 1978
(11) Entry to New Activities		01 October 1994	
(a) Leasing	Subsidiary	Subsidiary	
(b) Venture Capital	Subsidiary	Subsidiary	
(c) Securities Trading	Subsidiary	Regulated	
(d) Factoring	Directly	Directly	
(e) Consumer Finance	Directly	Directly	
(f) Credit Cards	Directly	Directly	
(g) Underwriting shares	Prohibited	Prohibited	Can underwrite bond and other debt instruments
(h) Custodian (i) Trustee and Guarantor	Approval required for capital market, otherwise can do as part of usual activities	no change	
(j) Securities Adm. Agency	Prohibited	Prohibited	
(k) Investment Manager	Subsidiary	subsidiary	
II. *Prudential measures*			
(1) Capital Requirements			
(a) Domestic banks	M$2 million	M$10 million	January 1981
(b) Foreign banks	M$5 million	M$10 million	
(2) Legal lending limits	Yes	Yes	
(3) Loan to deposit ratio	Yes	Yes	
(4) Capital adequacy ratio		8% by 1987	

Sources: Bank Negara Malaysia (1989); Bank Negara Malaysia (1994); Sheng (1996).

of development authorities. They are funded mainly by the federal government's development budget.

Market Entry

The October 1988 banking reform in Indonesia has significantly strengthened market competition. It has achieved this by relaxing restrictions on market entry, and by removing a 1967 regulation that gave state-owned banks special access to public sector funds. Since this banking reform, any state-owned enterprise has been allowed to hold up to 50 per cent of its deposits at private banks. The issuing of new bank licences, stopped in the early 1970s, was resumed, and new licences given to both domestic and foreign institutions. The reform also rationalized and relaxed the requirements for obtaining licences to operate in foreign exchange transactions and to open new branches. Whereas the national banks can open branch offices anywhere in the country, the foreign and joint venture banks were limited to opening one sub-branch each in the eight major cities.

Foreign banks can penetrate the Indonesian domestic market only through joint ventures with local banks. The foreign partners must already have representative offices in Jakarta, be reputable in their country of origin and be from countries that have reciprocal agreements with Indonesia. Domestic partners must be classified as 'sound' for at least 20 of the last 24 months. Although there is no regulation concerning establishment of new branches by foreign banks in Indonesia, no new licence has been issued. The maximum share of foreign partners in a joint venture bank is set at 85 per cent.

Table 9.6 indicates that the Herfindahl indexes of total deposits, loans and assets by bank ownership have been reduced sharply following the financial sector reform in Indonesia. A rapid drop – since 1988 – in all indexes for all banks indicates an erosion in the market power of the state-owned banks (including Bank Indonesia). This, however, was accompanied by the increasing market power of certain dominant private banks, some of which are technologically more advanced than the bureaucratic state-owned banks.

The index for the foreign banks group has not changed significantly since the reforms. Among foreign banks the Jakarta branch of the Bank of Tokyo may be the most affected; before the 1988 banking reform, it was the only Japanese bank that had fully fledged branches operating in Indonesia. As a result, it had a monopoly right to channel the lucrative Japanese foreign aid and loans to Indonesia and to handle financial transactions of all Japanese companies operating in the country.

Table 9.6 Indonesia: Herfindahl index of banking industries, 1981–91[a]

	All banks[b]			*Private banks*			*Foreign banks*			*Regional development banks*[c]		
	Total deposits	*Loans*	*Assets*	*Total deposits*	*Loans*	*Assets*	*Total deposits*	*Loans*	*Assets*	*Total deposits*	*Loans*	*Assets*
1981	0.145	0.157	0.151	0.092	0.064	0.078	0.111	0.117	0.122			
1982	0.122	0.157	0.144	0.084	0.061	0.077	0.124	0.150	0.138			
1983	0.110	0.148	0.141	0.080	0.063	0.076	0.133	0.116	0.121			
1984	0.107	0.144	0.142	0.072	0.066	0.070	0.127	0.112	0.134			
1985	0.107	0.139	0.142	0.069	0.066	0.070	0.109	0.107	0.130			
1986	0.112	0.142	0.146	0.069	0.066	0.075	0.107	0.115	0.133	0.081	0.071	0.073
1987	0.103	0.132	0.131	0.067	0.066	0.072	0.124	0.129	0.120	0.078	0.074	0.073
1988	0.102	0.125	0.123	0.066	0.064	0.072	0.124	0.129	0.128	0.080	0.075	0.078
1989	0.088	0.110	0.105	0.077	0.068	0.072	0.143	0.141	0.137	0.083	0.095	0.080
1990	0.084	0.094	0.097	0.089	0.069	0.082	0.145	0.140	0.136	0.092	0.079	0.089
1991	0.074	0.084	0.083	0.096	0.091	0.087	0.133	0.117	0.120	0.089	0.080	0.097

[a] The Herfindahl index (HI) is the sum of quadratic market share of each bank in the sample: $\sum_{i}^{n}(X_i/m)^2$ $i = 1\ldots n$ where X_i is the size of the i-th firm, n is the total number of banks in the sample and M is the total size of the sample banks. The Herfindahl index takes a value between zero and unity. HI equals unity corresponds to perfect concentration or monopoly and a value of zero coresponds to the perfect competition.

[b] From 1981 to 1990, there were 41 banks (5 state banks, 11 foreign banks and 25 private banks) included in the sample. In 1991, there were 42 banks (6 state banks, 11 foreign banks and 25 private banks).

[c] Regional development banks (1986–91) consisted of 27 banks.

Source: Perbanas, *Berita Perbanas*, various editions.

In contrast, Malaysia still protects its domestic banks from foreign competition, and gives special market preference to state-controlled banks. Of the 37 commercial banks operating in Malaysia in December 1994, 23 were domestic banks (with 749 branches) and the remaining 14 were foreign-incorporated banks (with 146 branch offices). To protect domestic banks, since 1966 the authorities have issued no new licences to foreign banks for establishing branch offices.

The 5 largest banks accounted for 53 per cent of total bank resources, 55 per cent of total bank deposits and 50 per cent of total bank loans. Special access to public funds is given to 2 leading government-controlled commercial banks, namely Bank Bumi Putra Malaysia Berhad and Malayan Banking Berhad. These 2 banks have 310 branch offices, or 31 per cent of the country's total of 995 bank branches. They also own 45 per cent of total assets of the domestically incorporated commercial banks, or 33.7 per cent of the total assets of all commercial banks in Malaysia (Table 9.7).

Prudential Rules and Regulations

Malaysia had managed to improve its prudential supervision and to develop monetary instruments prior to the liberalization of interest rates and credit policy in 1987. These, along with the contractionary demand measures (including restrictive monetary policy), have countered the expansionary impacts of the economic reform to help maintain short-term internal and external balances in the country. To have equal footing, effective from April 1988, pension funds and insurance companies in Malaysia are supervised by the Malaysian central bank. In Indonesia, such financial institutions are regulated and supervised by the relatively weak insurance commissioners of the Ministry of Finance.

Indonesia also has a much weaker legal and accounting system. Major laws on corporations, bankruptcy and the enforcement of contracts are obsolete and were inherited from the colonial era. A special accounting system for banks was introduced in January 1995. The long period of financial repression has eroded the central bank's capacity to regulate and supervise the banking system. It has also made the state-owned banks more bureaucratic and decreased their ability to select borrowers, administer credit and monitor how it is used, and recover matured loans. The problems have been exacerbated because the central bank and the state-owned banks are prone to political pressures.

Until recently, bank supervision in Indonesia was focused very much on regulatory functions. Relatively little work was carried out on quantitative

Table 9.7 Malaysia: concentration in the commercial banks, 1980–9

	1980	*1985*	*1989*
Share of 5 largest banks in commercial banks' total assets (%)[a]	57.1	50.2	54.0
Herfindahl concentration index	0.076	0.061	0.077

[a] The five largest commercial banks and years of their establishments or commencement of their businesses in Malaysia are: Bank Bumiputra Malaysia Bhd. (1966), Malaysian Banking, Bhd. (1960), United Malaysian Banking Corporation, Bhd. (1960), United Overseas Bank Ltd (1966) and Public Bank, Bhd. (1966).

Sources: Yan and Fan (1995) Table 5.13; (1995); Bank Negara Malaysia (1989).

risk analysis or on in-depth risk appraisal of individual institutions. Thus, when the risk positions of the banks increased following the liberalization, there was neither clear warning nor restraining action forthcoming from the supervisory authority. Similarly, Bank Indonesia failed to anticipate the consequences of credit expansion following the reform. The recent collapse or near-collapse of a number of domestic private banks such as Bank Duta in 1990, Bank Summa in 1992 and Bank Yama and Bank Pacific in 1995, and of the state-owned development bank Bapindo in 1993, illustrate the need to improve implementation of the new prudential standard. The new rules and regulations were introduced in February 1991. However, Bank Indonesia relaxed these rules in May 1993 because the banks were having difficulty in meeting the schedule of the prudential standard.

To strengthen implementation of the prudential supervision, Bank Indonesia has expanded the organization of its bank supervision from one department to three. The supervisory responsibilities of Bank Indonesia have also been substantially broadened to cover the BPRs and finance companies. Until February 1990, the BPRs were supervised by Bank Rakyat Indonesia, the state-owned agricultural bank, merchant banks by the Ministry of Finance. The Ministry of Finance also continued to supervise the leasing, factoring, and consumer financing activities of finance companies until December 1995.

The shift of prudential measures from the system of reserve requirement ratio to the risk-based capital standard in Malaysia was started in September 1981, with the introduction of a minimum capital adequacy ratio (CAR). The capital of the commercial banks was further strengthened by the authorities raising their minimum capital funds in February 1982. Effectively from January 1981, domestic banks have been mandated to each maintain a minimum capital fund of M$10 million (as compared to M$2 million previously), the equivalent of $3.8 million at the exchange rate of M$2.6 per $1 in 1981, and the minimum capital fund for foreign banks was raised from M$5 million to M$10 million. In the beginning, the CAR was defined as the ratio of 'free' capital, that is shareholders' funds, less investment in long-term assets to total assets. The ratios were set at 4 per cent for domestic banks and 6 per cent for foreign banks. A comprehensive revision of the capital adequacy ratio at 8 per cent, along the BIS recommendation, has been fully implemented since 1987.

The banking reform in Indonesia raises the required minimum capital for newly established banks and, although it has eliminated geographical discrimination it discriminates between domestic and joint venture institutions. In October 1992, the minimum required capital for newly established domestic and joint venture banks were doubled respectively to Rp50 billion and Rp100 billion (less than $25 million and $50 million, at the prevailing exchange rate of Rp2285 per $1). The risk-based prudential rules and regulations automatically require that each bank raises its capital base in line with the size and the quality of its assets. Thus, to strengthen their capital base, 22 private domestic banks raised funds by selling equities on the Jakarta Stock Exchange from October 1995 onwards.

The statutory reserve requirement ratio and minimum liquidity ratio have been actively used in Malaysia for achieving three objectives: first, as a prudential function, second, as an instrument for affecting the capacity of deposit money banks to generate loans (demand deposits) and hence money supply, and third, to help finance deficit of the public sector at large. Aside from paying inflationary tax for holding a non-yielding reserve requirement, the commercial banks are also required to absorb government securities, treasury bills and bonds issued by state-owned enterprises such as Cagamas, and the national housing mortgage corporation. Between May 1989 and 1994, Malaysia raised the reserve requirement ratio eight times, from 4.5 per cent to 11.5 per cent. In response to destabilizing capital inflows, in January 1994 Bank Negara Malaysia extended its application to include foreign currency deposits and transactions (such as foreign currency borrowings from foreign banks and inter bank borrowings). Prior to this, it had only applied to ringgit-denominated transactions (IMF, 1995: Box 1.4).

On the other hand, the money multiplier increased substantially as Indonesia reduced the reserve ratio from 15 per cent to 2 per cent in October 1988. Although it is still binding, the role of the reserve requirement is less important as a tool of monetary policy under the CAR system as long as the banks are under-capitalized. Under such a system, a bank with insufficient capital is required to shrink the size of its portfolio and/or to place greater emphasis on those assets with a low risk weight.

Credit System

Although the policy reforms have reduced distortions in the credit market, the credit policy remains segmented and pro-cyclical in both countries. This is because banks are still mandated to channel certain portions of their credit to specific economic sectors (such as agriculture) and specific classes of customers (such as small-scale enterprises and indigenous entrepreneurs in the case of Malaysia). Nevertheless, interest rates charged in these special credit programmes are now much closer to market rates and their insurance is voluntary, with market-based premia.

Four credit regulations were introduced between 1989 and 1990 in Indonesia.[7] The first is implied in the legal lending limits regulations (LLR). It sets limits on the aggregate amount of loans and advances (except credit programmes financed by Bank Indonesia's liquidity credit) to any insiders, whether they are single borrowers (persons or firms) or groups of borrowers. The second rule requires new joint venture banks and branches of foreign banks outside Jakarta to allocate at least 50 per cent of their loan portfolios to export-related activities. The third rule mandates domestic private and state-owned banks to allocate at least 20 per cent of their loan portfolios to small-scale enterprises and cooperatives (*Kredit Usaha Kecil*, or KUK). The fourth rule was introduced in January 1990, when Bank Indonesia narrowed the scope of the subsidized credit programme further to four areas, which include rice production, marketing, buffer stock and investment financing in the eastern part of the country.[8]

The objective of LLR and credit allocation is to democratize access to bank credits in order to inhibit concentration of financial power, protect the interests of uninformed depositors, and prevent misuse of funds by insiders. This is because, like in other Asian countries, through networks of ownership, business and management interlocking, most of the business conglomerates in Indonesia and Malaysia are affiliated with banks. As predicted by Stiglitz (1994), the LLR rules are difficult and costly to monitor and enforce, particularly in a country with weak legal and accounting systems, like Indonesia. To circumvent these rules, bank owners swap loans among themselves and industrial conglomerates use their banking units to give favourable treatment to their suppliers and customers.

Malaysia sets a single customer limit at 30 per cent of any bank's shareholders' funds, or net working funds in the case of a foreign bank, and an overall limit for large loans at 50 per cent of the total credit facilities. A large loan is defined as any loan that in the aggregate exceeds 15 per cent of capital funds. In addition, Bank Negara Malaysia issues lending guidelines that require commercial banks to channel certain percentages of their credit to certain classes of customers (such as indigenous community and small-scale enterprises) and to specific economic sectors (such as agriculture, manufacturing industry and residential housing). Both the definitions of beneficiaries and the percentage allocations of the credit are changing over time in line with changes in government policy. The 1994 Lending Guidelines issued on 31 March 1994, for example, require commercial banks to extend at least 20 per cent of total loans outstanding to the Bumiputra community and to purchase low-cost housing units. Established in 1993, the Credit Guarantee Corporation of Malaysia provides guarantee cover to commercial banks for loans extended to small-scale enterprises (including the hawkers and petty traders). Bank Negara Malaysia also provides refinancing facilities for export credit, and credit for the promotion of investment in primary food production and distribution.

Foreign Exchange Exposure

As noted earlier, both Malaysia and Indonesia adopt a liberal, open foreign exchange system with a unified exchange rate. However, commercial banks in these two countries require a special permit to deal in foreign exchange transactions, which are issued only to well-managed banks of strong financial standing. In addition, both countries try to influence the size and structure of short-term capital inflows through a number of quantitative and qualitative restrictions. The restrictions are aimed directly at limiting the size of external borrowings and/or at raising their effective costs. At present, there are four instruments being employed to influence the size and structure of capital flows into Indonesia. The first is a daily net open position (NOP), the rate of which can be varied according to the government's monetary policy; on 25 March 1989, this system replaced the set of complex ceilings on foreign borrowings of banks. The second instrument is the non-trade-related exchange rate swap facility at Bank Indonesia. Established in January 1979 to attract foreign investment, the swap facility offers a special exchange rate to domestic borrowers by providing explicit subsidy on the exchange rate. Under this facility, Bank Indonesia provided forward cover to foreign-currency liability. The swap premium was set below the level of the realized depreciation of the rupiah. The size of the subsidy also depended on the interest rates chosen to calculate interest rate differential. In reality, the swap facility was also used by the financial institutions either to fund themselves or to hedge or even speculate against a declining rupiah. The third instrument is the system of ceilings on offshore borrowings of state-related sectors, including those in the private sector that rely on public entities for their bankability. The last instrument is incorporated in the Income Tax Law of October 1994, made effective from 1 January 1995. It imposes a 0.1 per cent tax on the sale of shares and other certificates in stock market transactions (founder shareholders of listed companies are subject to an additional 5 per cent tax).

Malaysia mainly uses six instruments for limiting and raising costs of the short-term capital inflows. These measures include: (1) imposing limits on non-trade-related swap transactions of the banks; (2) imposing ceilings on banks' non-trade- and non-investment-related external liabilities; (3) requiring banks (from January to May 1994) to place with Bank Negara, interest-free, the ringgit funds of foreign banking institutions, which are referred to as Vostro accounts; (4) raising the statutory reserve requirement (SRR) ratio; (5) the prohibition of domestic residents from selling short-term money market instruments to foreigners; and (6) banning commercial banks from undertaking non-trade swap and outright forward transactions on the bid side with foreign customers. As has been pointed out earlier, the Vostro accounts were also considered part of the eligible liabilities base for the calculation of required reserves. In early 1994 alone, the SRR was raised three times by a cumulative 3 percentage points to 11.5 per cent in order to siphon off the increase of liquidity from the capital inflows. This penalised all banks, because it raised their cost of funds.

Quantitative restrictions or capital controls are perceived as inferior to a tax on foreign borrowings, which is regarded as the first best policy. In the short run, they are seen as made to measure devices to bring about reduction of capital inflows quickly without having to lower interest rates. In the longer run, however, the quantitative controls on capital movements have several major disadvantages. As they are inevitably involved with non-price rationing, they result in very different effective rates of tax on different domestic borrowers. They are also cumbersome to administer, and there is some potential policy rigidity or pressure group activity that ensures that restrictions, once imposed, are not eased or removed after the macroeconomic reasons for their introduction have been resolved. Because of such macroeconomic crisis-protection ratchet effects, the capital controls are subject to abuse and to dissipation because of inducements to rent-seeking, as allocations through quantitative controls inevitably involve non-price rationing.

The principal, less distorting alternative policy that may help reduce the motivation to shift capital around is the so-called 'Tobin tax' (Tobin, 1989; Eichengreen *et al.*, 1995), that is, a tax on financial transactions that involve a currency exchange. This includes a non-remunerated reserve requirement deposit at the central bank on deposits associated with direct borrowing in foreign currency. The tax should be a insignificant burden on exchanges in the goods and services market, on the labour market and on long-term capital investment. However, it would add significantly to the cost of short-term arbitrage to reduce speculative transactions. Such a tax increases government revenue, and reduces both speculative transactions and exchange rate volatility. The feasibility of collecting such a tax, however, depends on the existence of an international agreement to cooperate in imposing it. As of now, tax on short-term capital inflows is not covered in double-taxation treaties between nations. A high tax may act as a disincentive to borrow overseas, particularly on short-term maturities. Moreover, the high tax can be avoided or rerouted through other channels. These channels include over-invoicing of imports or under-invoicing of exports when export credits are exempted from the tax. In addition, a tax measure is a long-term solution, while excessive capital inflows are a temporary phenomenon only. As a result, it would be difficult to readjust the tax ratio once short-run capital inflows return to a more manageable level.

9.5 DISTRESS OF THE BANKING INDUSTRY

The transition process to the new competitive environment with stricter rules and regulations has been more difficult for the banking system in Indonesia, particularly for the state-owned banks. Unused to competition, these banks were concerned mainly with targets, and they were less concerned about developing new instruments, improving services, credit analysis and profitability. Recovery efforts were weak owing to problems, of moral hazard because most of the risks of the credit programmes were assumed by the state-owned credit insurance companies, by the central bank or by the Ministry of Finance. Recovery specialists are lacking, because this division was perceived as career-dead for state bank employees. Such internal problems for the commercial banks are less severe in Malaysia, because they are encouraged to compete in serving the target groups. Moreover, the financial repression was less damaging in Malaysia, because the system of credit ceilings was more general and the interest rates were closer to market rates.

The insolvency of financial institutions in Malaysia and Indonesia was brought about by a combination of the world-wide economic recession, which led to falling commodity prices in the first half the 1980s, with other factors. Many of the banks' corporate clients were highly geared, and their values of loan security were found to be no longer adequate after the drastic fall in prices of pledged assets. Much of these were in the form of land, property and shares in investment projects, which became less profitable because of economic reforms. The financial crisis broke in Malaysia in 1985. It started with the failure of the Overseas Trust Bank (OTB) in Hong Kong in July followed by the failures of a small leasing company (Setia Timor credit and leasing) in September and of twenty-four deposit-taking cooperatives (DTCs). The failure of Pan-Electric, a large, public-listed company in Singapore, had led to the closure for three days of the Kuala Lumpur and Singapore Stock Exchange. The failure was triggered by a run on a medium-size finance companies associated with a businessman with interests in Pan-Electric. Three other commercial banks (United Asia, Bank Perwira Habib and Sabah Bank) failed in 1986.

The number of bank crises that have led to closure, merger, take-over or the provision of large-scale assistance by the public sector is higher in Indonesia than in Malaysia. The much-publicized bank crises in Indonesia started with the failure of PT Bank Duta in September 1990, followed by the bankruptcy of PT Bank Summa in 1992, and the case of outright corruption at PT Bapindo, the state-owned development bank, in 1993. In 1995 Bank BNI, the healthiest state commercial bank, was assigned to take over two private banks, PT Bank Pacific and Bank Yama. Despite relatively high economic growth of over 6 per cent a year since 1990, problem loans by Indonesian banks appear not to have diminished significantly, though a combination of factors has made financial reports unreliable and it is difficult to estimate the exact size of the problem loans in the country. The first factor is the weak legal and accounting system. In addition, there was a practice of refinancing the problem loans to make them 'evergreen'. In February 1994, problem loans were estimated at \$7.5 billion in the seven state-owned banks and \$5.8 billion at private banks. The total sour loans – at \$13.3 billion – were equivalent to 16 per cent of the total credit of all commercial banks. Assuming the recovery rate to be 30 per cent, the potential loss for the state-owned banks amounts to \$5.25 billion, representing more than 2.5 times their entire paid-in capital, or 15 per cent of the government budget for fiscal year 1993/1994, or 4 per cent of GDP.

The bad debts need to be recovered, because they are financially parasitic, eating up capital and growing faster on capitalized interest rate that the banks will never see. The large-scale problem loans of domestic banks are concentrated in some 300 firms, particularly among the 50 politically well-connected business conglomerates. Land is the main collateral of banks' credit in Indonesia. As a result, the health of the banking system has depended on the ability and willingness of the conglomerates to repay their matured loans, on legal status and on land prices. Driven by easy bank credit following the October 1988 banking reform, land prices had risen significantly. The high capital gain from owning property, which was higher than the lending rates, attracted new investors and drove prices of land higher still. This is characteristic of a bubble process. The peak was reached in 1992, and since then land prices have lost most of their gains from the rise during the bubble period. Many real estate companies and developers, who had borrowed to acquire assets, have become insolvent. Many of these companies belong to major business conglomerates, which use their banking units to finance their speculative real estate business. This was exactly what happened to Bank Summa in 1992[9] and Bank Pacific in 1996.

Recapitalization is the costliest of the financial sector reform. As required, capital is proportionally linked to both the size and the quality of assets, and the banks' need to raise capital has been rising with the increase in the size of their total assets and problem loans. The problem has become more difficult because banks in Indonesia have traditionally depended on the central bank's refinancing facilities, and non-bank companies have relied heavily on debt financing at subsidized interest rates. Such a high debt-to-equity ratio represents few problems as long as the firms continue to grow and real interest rates remain very low or negative. However, a high-leveraged financial system exposes enterprises and banks to external and internal shocks, such as the rise in interest rates and reduction in economic rents that are happening in the process of economic liberalization. In particular, state-owned banks are undercapitalized, but inherited a much larger proportion of low-yield but high-risk programme loans.

Neither Malaysia nor Indonesia has any type of security funds such as deposit insurance for paying depositors' claims in cases of bank insolvency. In principle, owners and management of the banks are responsible for strengthening the capital base and solving the problem loans of their banks. However, when they cannot solve the problems themselves, the central banks usually step in. This is because central banks in both countries have traditionally a wide range of responsibilities to forestall systematic risk that might jeopardize public confidence in the banking system. The central bank may advise the problem banks to undergo a merger, consolidation or take-over by new investors, or provide them with fresh capital injections.

Bank Indonesia exercises its role as lender of last resort for upholding systemic stability in the financial markets on a case-by-case basis. Neither the size nor the terms of the liquidity and capital support programmes for rescuing the problem financial institutions have ever been made transparent to the general public. When PT Bank Duta collapsed in September 1990, owing to losses from foreign exchange speculation, it immediately received a capital injection of $419 million from the 'friends' of the three social foundations (all chaired by President Suharto), who are also the major shareholders of the bank. Of the insolvent banks, only PT Bank Summa was allowed to go bankrupt in 1992.

Bank Indonesia provides support programmes to insolvent domestic private banks on an *adhoc* and non-transparent basis. The supports include capital injections and other emergency financial supports, and they are made available to banks owned by those who are politically well connected. To strengthen their primary (tier I) capital, Bank Indonesia acquires shares of the problem banks and provides them with other types of equity capital. The central bank also provides loans, guarantees and other types of support to strengthen liquidity of the financially distressed banks. Aside from providing credit and buying equity shares, Bank Indonesia also arranges the merger, consolidation and take over of the problem banks either by stronger institutions or by new investors. As shown by the case of PT Bank Pacific, providing access to lender-of-last resort funding for the distressed banks on a continuous basis often committed Bank Indonesia to lend money to institutions that had no capital. Owners had no incentive to use the new money wisely, because they had nothing at risk. On 31 July 1995, Bank Pacific had Rp1 trillion sour loans, or about 40 per cent of its total assets, used mainly for financing car loans and real estate projects. To rescue Bank Pacific, Bank Indonesia had asked Bank BNI to inject fresh loans to it which were rediscounted at the central bank. The bank was originally fully owned by the family of General Ibnu Sutowo. When Bank Pacific collapsed in the early 1980s, Bank Indonesia rescued it by taking over 38.25 per cent of its equity share.

At present, the government has no resources to strengthen the capital base of its banks. On the other hand, the high non-performing loans have been largely responsible for the weakening of the net interest income of the state-owned banks. The interest income is, however, further squeezed by the rising interest rate on deposits. The severe market competition on both sides of their balance sheet makes it difficult for banks to raise the spread between lending and deposit rates as a way to pass at least some losses to prime customers. Meanwhile, only Bank Tabungan Negara and Bank BNI have met the criteria for raising equity capital in domestic capital markets.

The government of Indonesia has opted for various mechanisms to strengthen the capital base of the state-owned banks. The first was by borrowing the sum of $307 million as a Financial Sector Development Project loan from the World Bank on 12 November 1994;[10] In addition, state-owned (and domestic private) banks borrow long-term floating-rate notes from international capital markets that can be regarded as capital. The second means was to either convert some of the outstanding Bank Indonesia refinancing facility into the capital of these banks or to provide them with new credit lines. The third method was for the Treasury to take over part of the bad debts. The fourth was by shifting part of these banks' sour loans to state-owned insurance companies, such as PT Askrindo, PT Asei, and Perum PKK.[11] The fifth was to relax prudential standards by, among things, modifying the definition of capital and weights to calculate banks' portfolios, as shown by the revised prudential rules and regulations issued in May 1993. The sixth was to encourage, on a limited basis, the securitization of the non-performing assets. This included absorption of some of the problem loans at state-owned banks by state-owned enterprises or government ministries, as in the case of the huge loan losses of the state development bank Bapindo in dealing with the Golden Key Group.[12]

The way Bank Negara Malaysia, between 1988 and 1994, rescued the four insolvent commercial banks and 24 DTCs was by means of transparent mechanisms. The operation to rescue the DTCs was divided into four schemes involving over 685 000 depositors with about RM3.4 billion in outstanding deposits. The central bank made available a total of RM1.1 billion in soft loans at 1 per cent annual interest rate and RM280 million in commercial loans at 4 per cent per annum to the programme. Various solutions to the distressed DTCs have been tried thus they have been: de-registered by the Register-General of Cooperative Societies; banned from deposit-taking activities; sold to new investors; managed by appointees; and put in receivership. The management of three other distressed banks (United Asia, Bank Perwira Habib Bank and Sabah Bank) were revamped by the central bank in 1986. The capital base of the four insolvent commercial banks was also strengthened by a combination of the injection of fresh equity through right issues from the existing shareholders and financial assistance from the Bank Negara, the central bank.

Orders to freeze the operations of the insolvent commercial banks and DTCs in Malaysia, the lifting of the freeze orders, or the variation of the terms of the scheme to rescue them all require the sanction of the High Court. In contrast, the rescue schemes in Indonesia have been determined solely by administrative fiat. To identify and assist domestic banks to solve their problem loans, Bank Indonesia and the Ministry of Finance have established the State Bank Supervision Team for the state-owned banks and the Special Task Forces for private banks.

9.6 MONEY MARKETS

A list of financial instruments traded in money markets in Malaysia and Indonesia is provided in Table 9.8. Malaysia developed its money market in the first half of 1980s, mainly for selling government securities to finance public-sector budget deficits. The deficits have typically been financed by external borrowings and from domestic non-bank sources, particularly the EPF. In the beginning, treasury bills and other maturing government securities and investment certificates were the money market instruments traded in the Malaysian money market. Other financial instruments, such as profit-sharing investment certificates, housing bonds, floating rate negotiable certificate deposits, banker acceptance, and negotiable certificates of deposits were introduced during period 1988–9. Partly because of federal government budget surpluses and the privatization of state-owned enterprises, both public sector deficits and the amount of government securities have significantly declined.

To cope with the need to have instruments to conduct open market operations amid the rising short-term capital inflows, in February 1993 Bank Negara began to issue Bank Negara Bills (BNBs), which are similar to treasury bills and Malaysian Saving Bonds (MSB). Established in 1990, the Rating Agency Malaysia Berhad (RAM) is assigned to rate non-bank corporate issuers of debt securities. In addition, private companies who wish to issue bonds were required to obtain prior approval from the central bank.

Indonesia, in contrast, has no domestic government debt, because the government has a policy of financing its budget deficit through external debt, preferably at concessionary terms from official sources. The money market was introduced in April 1984, nearly a year after the first stage of banking reform on 1 June 1983, which reduced the scope of the credit programme and liberalized interest rates. Since then, the SBI (Bank Indonesia Certificate) has been the most important money market instrument. The *Surat Berharga Pasar Uang* (SBPU), a second money market instrument, was introduced in February 1985. The SBPU is a short-term bill in the form of a promissory note or trade bill co-signed by a bank or NBFI, which can be rediscounted at Bank Indonesia. Because the market has not worked effectively, at times, the Ministry of Finance and Bank Indonesia have forced the state banks and non-bank, state-owned companies to buy SBIs. A small amount of bonds have been issued by Bapindo, some regional development banks, a state-owned toll road company (PT Jasa Marga) and a small number of private companies. The number of corporate bonds and commercial papers issued by state-owned and private non-bank companies is expected to increase following the establishment of PT Pefindo, a privatly owned rating company, in 1995.

9.7 THE IMPACTS ON MONETARY AGGREGATES

One problem associated with the financial reform has been the erosion of the autonomous power of the monetary authorities to direct monetary policy at domestic policy targets in order to preserve internal and external stability. As will be discussed later, the erosion of monetary policy has been happening in Malaysia and Indonesia since long before the financial sector reforms were initiated in the 1980s. The reason has been the rising roles of less regulated NBFIs – non-bank financial institutions, which operate much like commercial banks.

Controls on Monetary Aggregates

In the beginning, the financial sector policy reforms in Malaysia and Indonesia brought about major changes in the financial system that caused shocks both in the money supply and in the money demand function. The end of direct control on interest rates and credit rationing has made interest rates the opportunity cost of holding money and has raised the usefulness of interest rates for monetary policy. The rise in interest rates, however, has ignited portfolio shocks and altered the characteristics of money demand function. Although market interest rates have risen, the effective rates may have fallen following the reforms, certainly at the margin. In the old system of financial repression, the official interest rates were low, but effective marginal rates were high because the credit was rationed. To a certain extent, household interest rate payments are tax-deductible, lowering the effective interest rates. This raises the demand for credit at any

Table 9.8 Malaysia and Indonesia: money market instruments

Country/type of instrument	*Issuers*	*Date of introduction*	*Major buyers*
I. Malaysia			
(1) Treasury bills	Treasury	March 1955	CB and DH
(2) Government securities	Treasury	1961	EPF and CB
(3) Investment Certificates	Treasury	July 1983	Bank Islam
(4) Central Bank Certificates	Bank Negara	1979	Selected financial institutions
(5) Commercial bills:			
(a) Trade bills			
(b) Banker acceptance		May 1979	
(c) Negotiable certificates of deposits (NCD)	CB and FC[a]	May 1979	
(6) Cagamas bonds	Cagamas	December 1988	
(7) Floating rate NCD	CB and FC	June 1988	
(8) Private corporate bonds	Private companies	January 1987	
(9) Promissory notes			
II. Indonesia			
(1) Central bank certificates (SBIs)	Bank Indonesia	April 1984	CB and NBFIs
(2) Surat Berharga Pasar Uang (SBPUs)	Non-bank private companies, but endorsed by banks	February 1985	CB and NBFIs
(a) Trade bills			
(b) Promissory notes			
(3) Corporate bonds			NBFIs
(4) Bonds issued by financial institutions			
(5) Negotiable certificates of deposit			NBFIs

CB = commercial banks; DH = discount houses; EPF = employees' provident fund; FC = finance companies; NBFIs = non-bank finance companies.

[a] The amount of Negotiable Certificates of Deposit (NCD) that a commercial bank or finance company can issue is subject to a limit set by the central bank, based on the issuer's capital funds.

level of interest rate. On the other hand, the new rules and regulations on commercial banks also affect the money supply function, making the developments in money supply and credit aggregates more difficult to interpret. Under the present risk-based capital standard, an expansion in loans (assets) of a commercial bank is linked directly to the size of its capital. Unlike in the system of reserve ratio, a commercial bank cannot simply borrow funds from surplus institutions in order to increase its capability to make loans. In the credit ceiling model, the authorities determine directly the amount of an individual bank's loans, independently of the level of its reserve deposits and capital base. Under the CAR system, those banks with limited capital were forced to shrink the size of their capital portfolio or to replace greater emphasis on those assets with low risk weight and, therefore, a lower capital cost.

A combination of the rise in domestic interest rates, of market expectations of changes in local currencies and of liberalization of capital accounts has attracted larger private sectors capital inflows to both Indonesia and Malaysia enabling the financing of larger current account deficits and the accumulation of international reserves in both countries. Meanwhile, the structure of the private capital inflows has also been moving more towards short-term private flows. Commercial bank loans remain the main type of private capital inflows to Indonesia. Meanwhile, the share of portfolio investments through capital and money markets has been rising fast in Malaysia. In an open economy with a fixed exchange rate and more developed financial markets, monetary policy is less effective, because it can affect only the composition of liquidity. To maintain the same level of money supply, the increase in international reserves from a surplus in the current account should be accompanied by a reduction in domestic credit (either from the central bank or commercial banks) by an equivalent amount; otherwise, the credit expansion ignites inflation and reduces interest rates. Massive capital inflows also tend to appreciate domestic currency and to lower prices and wages.

During the early period following the financial liberalization, capital inflows were effectively controlled and financial markets were relatively underdeveloped in both Malaysia and Indonesia. These allowed sufficient autonomy for the interest rate and exchange rate objectives to be treated separately. The ability of the central bank to raise domestic interest rate has drastically diminished as the capital movements have became increasingly interest-rate-sensitive. Internationalization of financial markets makes capital flows increasingly sensitive to interest rate differential and exchange rate expectations. As a result, monetary policy has become more complicated, constrained as it has been by foreign economic policies and events. As we saw earlier, this, and the inadequate size of the available money market instruments to mop up the capital inflows, have forced the authorities to reimpose stricter quantitative and qualitative controls on short-term capital inflows. Because these are perceived as inadequate, both countries are willing to use the central banks and state-controlled firms as fiscal agents to mop up the excess reserves.

The developments of components of monetary bases in Malaysia and Indonesia, shown in Figure 9.1, indicate the different responses of monetary policy to the surging capital inflows in the 1990s. The annual rates of growth of M1 in Malaysia and Indonesia were around 36 per cent and 25 per cent, respectively, between 1992 and 1994. To keep the nominal external value of the ringgit stable, the authorities in Malaysia sterilized much of the short-term private capital inflows. The other part of the capital inflows, which initially were in the form of bank deposits, did not have a significant impact on lending, because they were absorbed as excess reserves of the banking system at Bank Negara Malaysia. The combination of these policies has resulted in the continuous buildup of the net foreign assets of the banking system.

The rapid rates of growth of both the domestic and the foreign assets of the Malaysian banking system had reduced commercial banks' (lending) interest rates between 1993 and the first quarter of 1994 (Figure 9.2). Beginning in February of that year, the ringgit was allowed to slightly appreciate (Figure 9.3). Starting from the second quarter of the same year, the interest rates were moving upward slowly, because of the increasing sterilization operations and quantitative restrictions on capital inflows imposed by the authorities. The interest rates, further increased owing to more stringent restrictions, were put in place to minimize the contagion effects of the tequila effect the currency crisis in Mexico in late 1994, which was felt in Asia, after a time lag, in the first quarter of 1995. To hold back further rises in interest rates, Bank Negara Malaysia defended the external value of the Malaysian ringgit by intervening in the foreign exchange market. This reduced the net foreign assets of the banking system.

Monetary policy in Indonesia is constrained by the financially distressed domestic banking system. The ability of Bank Indonesia to raise interest rates and the ratio of the reserve requirement is limited, because this would further weaken the banking system. In addition, the bailout of the banking system has contributed to the acceleration of Bank Indonesia's net domestic credit. Part of the capital inflows is used to strengthen the capital of domestic banks. Figure 9.1 shows a rapid growth of the net domestic assets of the banking system at the cost of a sharp erosion in its net foreign assets in 1989–90. There was a sharp decline in net domestic assets of the banking system in 1991, as a result of the instruction of the Minister of Finance Dr J.B. Sumarlin, in February of that year, to a number of large state-owned enterprises to switch their deposits at state-owned banks into SBIs. This initially withdrew Rp7 to Rp8 trillion ($3.64 to $4.1 billion at the then exchange rate of Rp1923/$) from the monetary base. The net withdrawal amounted to Rp2 trillion, as Bank Indonesia offset part of the sale of SBI with its purchase of SBPUs.

The interest rates in Indonesia, as measured by cutoff rate in auctions of 90 days SBIs, peaked in March 1991 following the Sumarlin shock in the previous month. Interest rates started to move upward again in the first quarter of 1995, following the Tequila effect. As in Malaysia, Bank Indonesia also intervened in the foreign exchange market, depleting its foreign exchange reserves by between $500 and 600 million to defend the external value of the rupiah and hold the rise in interest rates.

As indicated earlier, exchange rate policy plays two roles. On the one hand, jointly with other policies, it plays an important role in promoting both external and internal macroeconomic stability. On the other hand, exchange rate policy, also jointly with other policies, helps to maintain the international competitiveness of the domestic economy. There is no indication that Malaysia and Indonesia have used the exchange rate as a nominal anchor and have allowed the rupiah to appreciate as an instrument for generating fiscal revenues and curbing domestic inflation rates. As a matter of fact, the authorities in both countries have used the exchange rate policy to correct 'the Dutch disease' problem, or the appreciation of their domestic currencies, since the oil boom period in the 1970s.[13] As shown in Figure 9.3 (for Malaysia) and Figure 9.4 (for Indonesia), in general, both countries have been using the same exchange rate policy to encourage the production and exports of non-oil traded goods, to curb both domestic demand and imports and to attract capital inflows. The figures, however, indicate that both nominal and real effective exchange rates have been recently appreciating that have been aimed at reducing in both Malaysia and Indonesia. This is partly as a result of government policies in these countries the high cost of the sterilization operations of the large capital inflows through enlarging the intervention bands of their currencies, so as to allow market forces a greater role in setting the exchange rates. Concurrently, greater exchange rate flexibility introduces uncertainty, which may well discourage part of the purely speculative capital flows and allow a higher degree of freedom for the monetary authorities to exercise control over monetary aggregates.

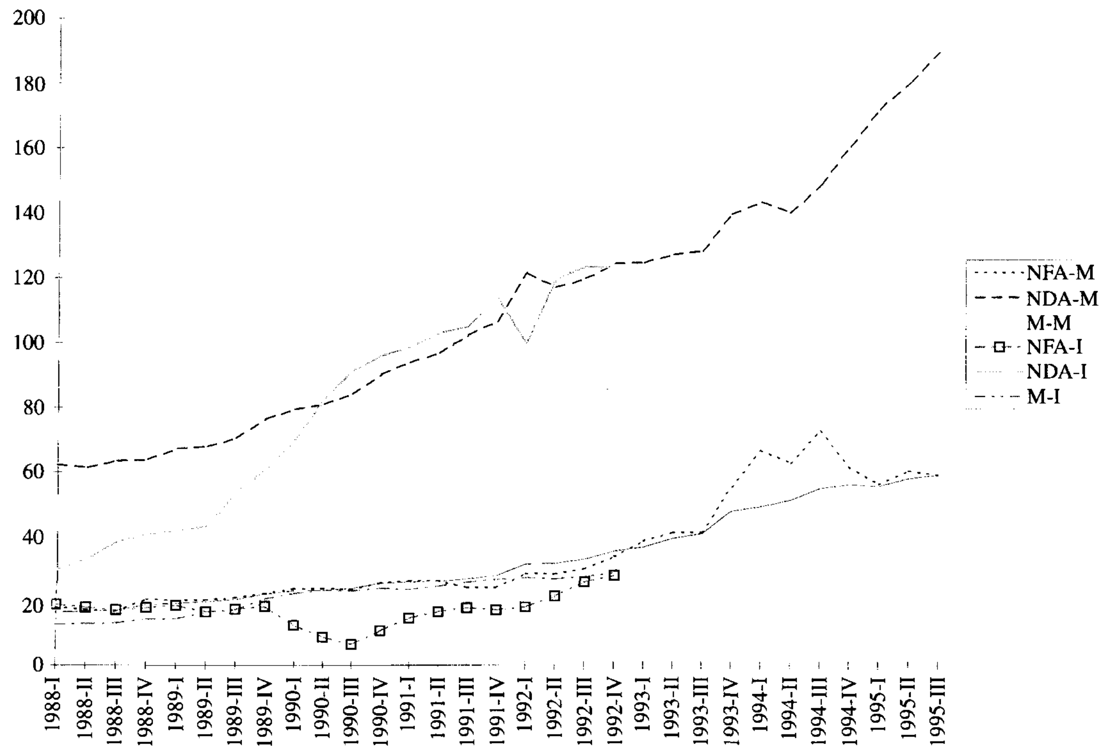

Figure 9.1 Malaysia and Indonesia: components of monetary base 1988–95 (billion in local currencies)

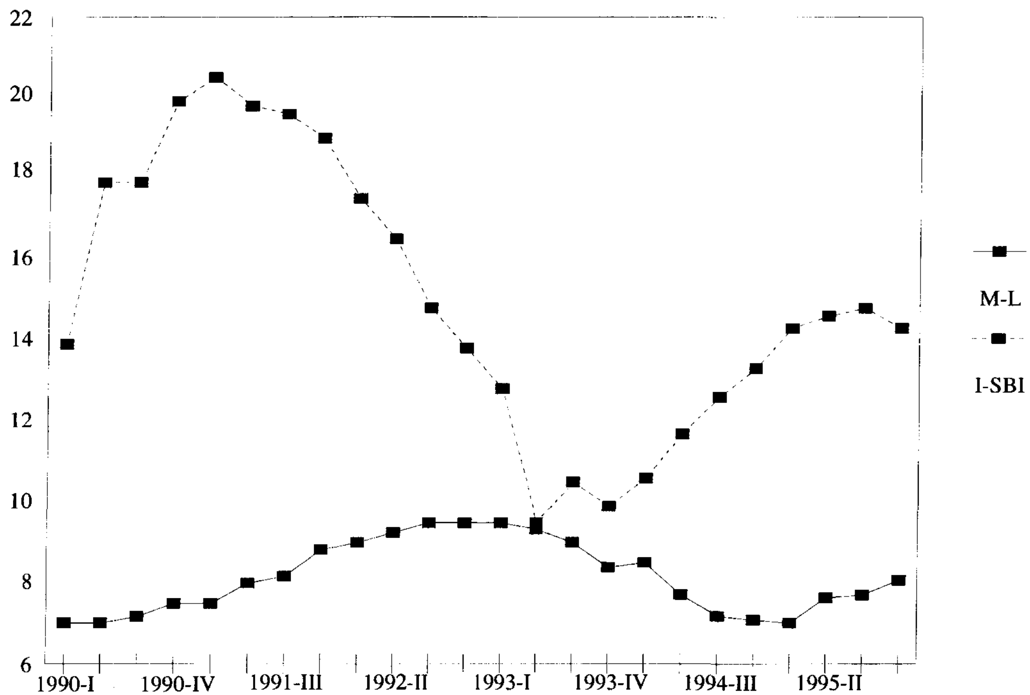

Figure 9.2 Malaysia and Indonesia: developments of interest rates, 1990–5 (% per annum). Lending rates for Malaysia (ML) and cutoff rate in auctions of SBI for 90 days
Source: IMF, *International Financial Statistics*, for Malaysia; and Bank Indonesia, *Weekly Report*, for Indonesia, various issues.

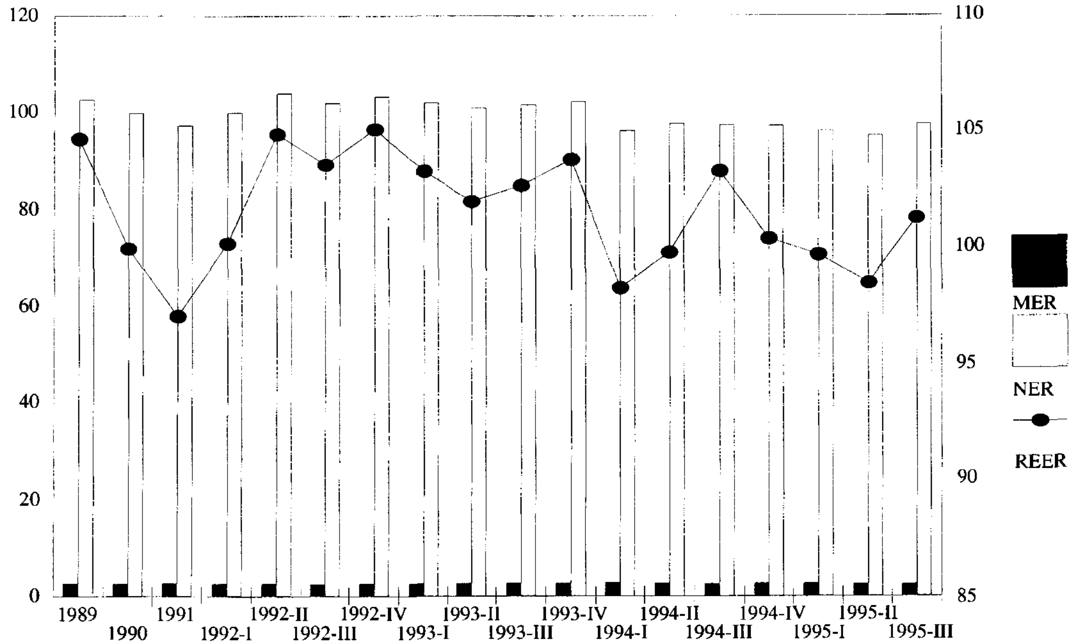

Figure 9.3 Malaysia: market exchange rate, nominal effective exchange rate (NER) and real effective exchange rate (REER), 1988–95

Source: IMF, *International Financial Statistics*, various issues.

MER is the period average market exchange rate, NER is nominal effective exchange rate (expressed on base 1990 = 100) and REER is the index of real effective exchange rate. REER is defined by the IMF as 'nominal effective exchange rate index adjusted for relative movements in national prices or cost indicators of the home country and its partners-or-competitor-countries'.

The Non-Bank Financial Institutions (NBFIs)

As noted earlier, the autonomy of monetary authorities in conducting monetary policy in both Malaysia and Indonesia was greatly reduced or lost long before the financial sector reform. The repressive rules and regulations in the financial sector were felt mostly in the state-owned banks (in the case of Indonesia) and the state-controlled banks (in the case of Malaysia). The rapid growth of unregulated investment finance companies and merchant banks had increased the share of the grey market during the era of the 'oil boom' in the early 1970s. The finance companies are the second largest group of deposit-taking institutions in both Malaysia and Indonesia. Merchant banks are licensed to operate as specialized financial intermediaries in the money and capital markets. In reality, however, merchant banks have operated like finance companies in Indonesia. As noted earlier, prior to the recent reforms, the non-bank financial institutions in Indonesia were regulated and supervised by the Ministry of Finance. However, they were practically unregulated owing to the low supervisory capability of the Ministry of Finance. As a result, the authorities found themselves with the a choice of either letting the unregulated markets dominate the state-owned banks or else permitting financial reform and accepting some associated erosion of the autonomy of state-owned banks. On the external side, capital flows were also rising because of increasing transactions with foreigners and the internationalization of the business sector.

Except that they are prohibited from accepting demand deposits, in reality, the operations of the investment finance companies are very similar to those of commercial banks. The finance companies are allowed to accept savings and time deposits with a minimum of three months' maturity from the general public. Loans extended by the finance companies are mainly instalment-plan loans, leasing finance, housing loans, and loans for a variety of other purposes, particularly for the purchase and development of real estate and other durable investment and consumption goods. The finance companies are, therefore, the competitors of commercial banks in providing short-term business financing and consumer credit. Unlike the heavily regulated banking sector, particularly the state-owned banks, the investment finance companies were unregulated. The operations of these financial institutions are constrained only by regulations on gearing ratio, that is, the maximum an investment finance company may borrow in relation to its own shareholders' fund (limited to fifteen times in both countries), and the ceiling on foreign borrowings. This freedom of action has permitted the investment finance corporation to adapt more

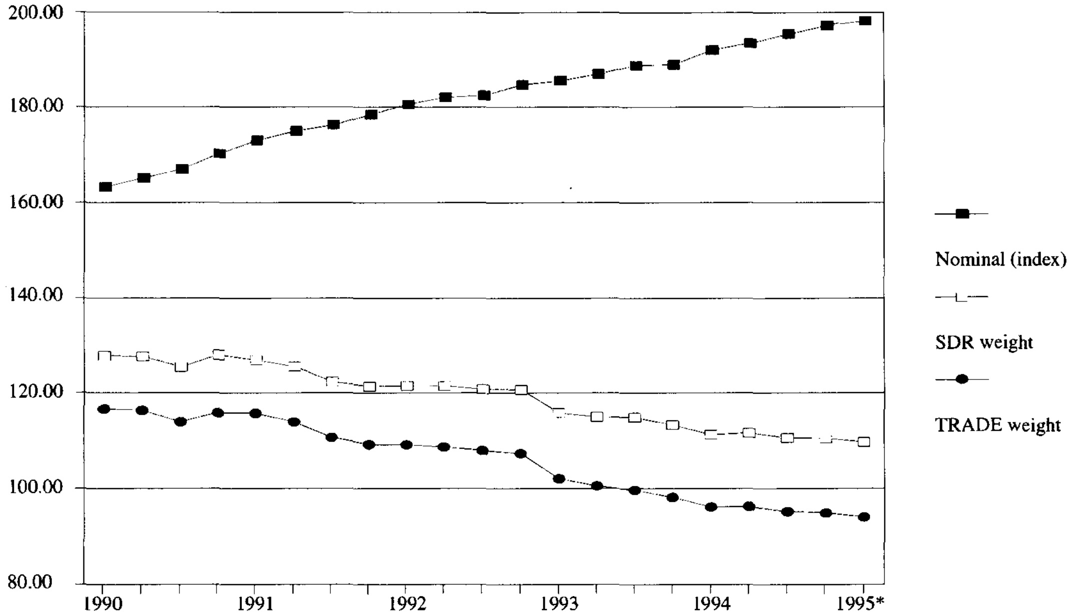

Figure 9.4 Indonesia: real effective exchange rates (REER), 1990–5 (1985 = 100)
Note: Real effective exchange rate (REER) are calculated by the equation $(e^{*}pf)/p$, where e is the exchange rate, pf the foreign CPI, and P the domestic CPI. The SDR and TRADE valuation basket consist of the currencies of the five members having the largest exports of goods and services during the period 1985–9, the weights for SDR being US$ 42%; Japanese yen 19%; DM, French franc and British pound sterling 13% each; the weights for TRADE were: US$ 3.68%; British pound sterling 2.6%; Japanese yen 59.85%; French franc 1.89%; DM 4.96%. Beginning 1 January 1991, the weights for SDR were US$ 40%; DM 12%; Japanese yen 17%; French franc and British pound sterling 11% each.

rapidly and effectively to changes in the economic and financial situation than the banks. To attract large-denomination certificate deposits, finance companies have offered higher deposit rates than those offered by commercial banks. In Indonesia, these institutions were also being used by the state banks and Bank Indonesia to extend short-term credit and to invest in sectors and activities that the banks themselves could not reach during the previous financial repression. These practices ended with the elimination of the repressive system of credit ceilings cum selective credit policy with subsidized interest rates in January 1990. As their experiences had been mostly in providing short-term credit, the twelve investment finance companies in Indonesia opted to become commercial banks in 1992.

As noted earlier, other finance companies (such as leasing, factoring, consumer financing and credit card companies) in Indonesia were by law regulated and supervised by the Ministry of Finance (MOF) until December 1995. Because the MOF has no capability to implement the supervisory tasks, these institutions were, in reality, unregulated and unsupervised. Following the financial sector reform in the late 1980s, the finance companies were the main suppliers of housing and car loans and other types of consumer credit. In both countries, these institutions have also been used as 'cash dispensers' to buy shares of companies owned by the politically well-connected private sector business conglomerates.

9.8 CONCLUSIONS

All the financial indicators (M1/GDP, M2/GDP, TAFI/GDP, and market capitalization/GDP) point to the financial system of Malaysia being more developed than that of Indonesia. Aside from having a much higher level of income per capita, this country has a relatively more stable economy and social system than that of its neighbour. Moreover, prior to recent reforms, the financial repression in Indonesia was much longer and more severe than in Malaysia. In terms of assets and of the number of institutions, however, the banking system remains the core of the financial system in these countries. Other financial institutions are fast-growing segments of the system, but their roles have not been as important as that of the banks.

The technocrats are liberalizers in Indonesia. As advisers to the government, they may not have formal executive positions. But they are still powerful, and are listened to by their successors and foreign lenders. Whereas Bank Indonesia has tended to retain direct controls on the banking system, Bank Negara Malaysia has been the initiator of financial sector reform in Malaysia and the Ministry of Finance has played a supporting role.

Indonesia has adopted a different sequencing of both economic and banking sector reforms since the early 1980s. In general, the coverage and speed of policy reform in the financial sector has been much wider and faster than in the real sector of the economy. The banking sector reform started in June 1983, with the relaxation of controls on interest rates and the elimination of sectorial loan allocations. However, the short-term money market was only beginning to develop in April 1984. A more drastic reform was introduced in October 1988, but new prudential rules and regulations were announced only two years later. Furthermore, as many of the banks, including the state-owned banks, were having difficulty in meeting the prudential standards, the authorities have had to retreat by relaxing the rules and regulations. Because a legal and accounting system cannot be built overnight, the focus of bank supervision in Indonesia is likely to remain more on the regulatory aspects of the supervisory functions. Inherited from the colonial past, the basis for securing contract and credit transactions is weak, while the laws and procedures on exit and bankruptcy are unclear. Financial disclosure is poor, owing to the weakness in the implementation of accounting requirements and in the standards and training of public accountants.

In contrast, Malaysia implements a gradual but more consistent approach of financial sector deregulation, accompanied by a more proper sequencing as prescribed by the textbook. In contrast to Indonesia, Malaysia retains special-purpose banks, heavily protecting its domestic banks from foreign competition and giving special market preferences to state-controled institutions. Traditionally, Malaysia has a modern and adequately good market infrastructure. Partly in order to dump public sector debt, Malaysia developed a short-term money market in the early 1980s, before it deregulated interest rates in 1987.

The transition process to the more competitive environment and stricter rules and regulations has been more difficult for the banking system in Indonesia. The problems are not limited to the state-owned banks, which are traditionally undercapitalised, and to the inherited larger portion of low-yield but non-performing assets from the past credit programme; the number of bank crises among the private banks has also been rising in recent years. In contrast, insolvency in Malaysia occurred only in the 1980s, involving a single commercial bank and a number of deposit-taking cooperatives.

Both Malaysia and Indonesia have neither compulsory nor voluntary security funds, such as deposit insurance. In principle, the owners and managers of the banks are made responsible for strengthening the capital base and for solving the problem loans of their banks. However, when they cannot solve the problem themselves, the central banks usually step in to prevent systematic risks that might jeopardize public confidence in the banking systems of their countries. Nevertheless, it is not very clear how the central banks in both Malaysia and Indonesia exercise their role as the lender of last resort to prevent systemic risks in the financial markets.

The exchange policy in Malaysia and Indonesia has been used mainly to help maintain international competitiveness of domestic economy. In the case of Indonesia, however, the weak financial condition of the banking system has limited the ability of the central bank to exercise monetary policy, raise interest rates and decelerate domestic credit. Higher interest rates worsen the financial conditions of the commercial banks and raise the interest burden of Bank Indonesia's certificates of deposits.

Notes

1. Deposit money banks (DMBs) are commercial institutions whose demand deposits are important or form a large share of their total liabilities. Although the commercial banks are the main component of DMBs, other special purposes financial institutions such as development, savings, and cooperative banks may also included in this category when their liabilities are regarded as money (see IMF Institute, 1981).
2. Includes savings deposits and NOW accounts, automatic transfers service accounts at banks and thrifts institutions, and share draft accounts held at credit unions or cooperative banks.
3. Prior to the present form, JSE was reopened on 4, June 1952 after being closed since the beginning of the World War II. However, owing to economic and social instability its activities were again officially suspended in 1968. In August 1995, the less active Surabaya Stock Exchange was taken over and merged into the Parallel Bourse of Jakarta, to allow smaller companies with good growth prospects to have access to the capital market, for example via the second board established in Kuala Lumpur in November 1988.
4. Until 1989, PT Danareksa had a special right to buy at least 50 per cent of every new issue in the first instance, but no obligation to purchase any percentage of an issue. Once PT Danareksa has taken up a percentage of an issue, it places the shares in its investment portfolio and may then issue bearer certificates, relating to the specific companies backed by certain percentage shares in its portfolio, in small denominations which it sells to general public in order to democratize the companies' ownership. Foreign investors were banned from the security markets. Until October 1988, income from investment in financial securities was subject to 15 per cent withholding tax, while interest on bank deposits was free from such tax.

5. Under the leadership of Professors Widjojo Nitisastro (the former Minister of Development Planning) and Ali Wardhana (the former Minister of Finance) the 'technocrats' have been the architects of the economic development of Indonesia since 1966. The group consists of professors of the Faculty of Economics at the University of Indonesia.
6. State-owned enterprises in Malaysia are defined as those with more than 50 per cent of their equity held by the government. In the mid-1980s, there were 56 non-financial state-owned enterprises, but this number was gradually reduced to 42, as of the end of 1993, through privatization. The privatization includes transfer of the equity ownership to the private sector of the following companies: PETRONAS (the petroleum company), Telekom Malaysia Berhad (TMB), Tenaga Nasional Berhad (TNB), Malaysian Airlines (MAS), Cement Industries of Malaysia, Edaran Otomobil Nasional, Sports and Toto Malaysia and the Heavy Industries Corporation of Malaysia (HICOM Holding Berhad). On the performance, problems and prospects of privatization of state-owned enterprises in Malaysia see, among others, Mohammad Sheriff bin Mohammad Kassim (1991) and on criticisms to the programme see articles edited by K.S. Jomo (1995).
7. Aside from formal budgetary and credit programmes, Indonesia has also a number of semi-formal schemes to help finance the cooperatives and small-scale enterprises and poverty alleviation programs. These include a decree issued by the Minister of Finance in 1989 to require all state-owned enterprises, including banks, in Indonesia to channel between 1 and 5 per cent of their profits to provide funds to the cooperatives and small-scale enterprises at concessionary terms. Domestic conglomerates have been called to donate between 1 and 25 per cent of their listed shares to those sectors. In December 1995, the President and a group of cabinet ministers, the Director General for Taxation and private businessmen, in their private capacity, established the Yayasan Dana Sejahtera Mandiri (Self-Reliant Prosperity Funds). The foundation aims to help the government's poverty alleviation programme under the coordination of the office of the state Minister of Population. The target funds collection is Rp1.15 trillion, to be loaned to 11.5 million poor families: Rp100 000 each, with interest at 6 per cent per annum. Presidential Decree no. 90 of 1995 calls on individual and companies with income tax of more than Rp 100 million per annum to donate up to 2 per cent of their earnings to the foundation.
8. At the end of 1990, this concessionary credit was made available for BPPC (Badan Penyangga dan Pemasaran Cengkeh) to finance its buffer stock of cloves, the main ingredient of clove cigarettes. The recipient of this credit is a consortium of private traders who have powerful political backing and have been granted the exclusive right to operate a buffer stock for that agricultural commodity.
9. The collapse of Bank Summa in 1992 has resulted in the loss of control over the flagship company of the Surawijaya family, PT Astra International, then the largest company listed on the Jakarta Stock Exchange.
10. The World Bank, *Annual Report 1993*, Table 7–5, p. 177. This amount is much less than the amount of capital injected into PT Bank Duta ($419 million), a relatively much smaller private bank, in September 1990, to cover its losses from foreign exchange speculation. The injection come

from outright gifts from the 'friends' of the three social foundations (all chaired by President Suharto), the major shareholders of the bank.

11. PT Askrindo is a state-owned insurance company, established in 1974, primarily to insure the past investment and working capital credit programme for medium and small-scale enterprises (KIK and KMKP programmes). PT Asei is a state-owned export insurance company, and Perum PKK a state-owned company for insuring credit for cooperatives. Mainly because of insuring the excess credit of commercial banks above their legal lending limits, PT Askrindo accumulated losses amounted to Rp390 billion ($1987.52 million) in 1992, equivalent to nearly ten times its paid-up capital.
12. The trials of former Directors and key officials of Bapindo allegedly indicate that Admiral (ret.) Sudomo, the then Coordinating Minister for Security and Political Affairs, and Professor J.B. Sumarlin, the then Minister of Finance, were, between 1989 and 1992, directly involved in arranging unsecured loans from the bank to the Golden Key Group (originally in partnership with President Suharto's son Tommy Mandala Putra) of the sum $565 million for financing highly inflated investment costs of petrochemical projects. All former Managing Directors and key official of Bapindo were sentenced to various terms of imprisonment, and Mr Edi Tansil, the owner of Golden Key Group, was sentenced for 17 years prison term in August 1994. At present, Mr Sudomo is the Chairman of the Supreme Advisory Council and Dr Sumarlin the Head of Supreme Audit Board. With the help of a bribed chief warder, Eddy Tansil escaped from Jakarta's Cipinang prison on May 4, 1996.
13. Following the partition of Singapore from the Federation of Malaya, Malaysia terminated interchange ability of the Singapore dollar at par with the Malaysian ringgit on 8 May 1973. This was followed by the introduction of a freely floating Malaysian dollar regime in the following month on 21 June. Indonesia replaced the nominal anchor of the rupiah from the US dollar to as undisclosed basket of convertible currencies in November 1978. Because the growth of their economies depends on non-oil exports, the central banks in these countries monitor exchange rate developments against baskets of currencies and intervene in the interbank foreign exchange markets to influence the external value of their respective national currencies.

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