A Study on the Indonesian Financial Sector

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(A Study on the Indonesian Financial Sector)

Contents

Abstract

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This thesis examines the structure of the Indonesian financial sector, the process of reforms, before and after the financial crisis and suggestions to restore the positive functions in the financial industry.

The Indonesian financial industry has been predominated by the banking sector. The banking sector consists of the central bank(Bank Indonesia), state-owned commercial banks, private commercial banks, foreign banks, joint venture banks, province development banks and a countless number of Bank Perkreditan Rakyats(villiage banks)

The Indonesian financial system has moved toward a more market-based system since the early 1980's. A series of reforms liberalized the interest rate, entry of new banks, branching, and so on. Reforms have changed the Indonesian economy substantially. As a result, the reforms became one of the most important causes of the Indonesian financial crisis in 1997 because the liberalization occurred too fast compared to the reality of the Indonesian economy.

The reforms triggered the increase in the inflow of foreign capital, especially short-term external capital. The Indonesian financial system was not equipped with good infrastructure to protect itself from external shock.

The Indonesian foreign exchange rate system had an intervention

band and the Indonesian Rupia’s value was closely connected with the US dollar. The external competitiveness of the Indonesian economy was critically impaired when the Chinese Yuan and the Japanese Yen depreciated in mid-1990’s. The weakness of the low external competitiveness snowballed into a deficit of current account and foreign debts.

The non-performing loans of Indonesian banks have increased rapidly during the 1990’s due to the lack of capability of the Indonesian financial institutions to analyze customer’s credit and the feasibility of projects. Furthermore, excessive competition among financial institutions, abundant liquidity caused by foreign capital inflow, the principal-agency problem of some private banks of big conglomerates and the long-term economic boom deluded the financial institutions.

Indonesia has pursued a balanced budget. The Indonesian government has made its best efforts to decrease the budget deficit. However, it was not effective because there were too many exceptions such as strategic industries, and so on.

The Indonesian government requested the IMF rescue package and an IMF rescue package program totalling in the amount of 40 billion US dollars was signed in November 1997. The IMF requested the Indonesian government to implement a fiscal stabilization program and also to restructure the banking sector. The main purposes of reforms were the stabilization of the Rupia and the restoration of confidence in the Indonesian banks from the international financial market.

The Bank Indonesia’s banking sector reforms are focusing on re-capitalization, improvement of prudential regulation, reform of the bankruptcy law, merger, suspense and take-over of unsound banks.

My suggestions on ways to improve the banking system are as follows.

First, the evaluation of the bank personnel should be measured by their performance.

Second, the banking system should be transformed from a highly hierarchical generalist organization to a flat expert organization.

Third, it is extremely important to establish justice in the economic system. The defaulted borrower should be severely punished.

Chapter I. Introduction

1. Purpose of the Thesis

Notwithstanding much controversy, many people have praised the East Asian economic miracle just until a year and a half ago. The East Asian countries collapsed suddenly with no due notice. What makes it more notable for Indonesia is that it had retained a very sound economic situation. But there were many hidden reasons that caused the Indonesian economy to go bankrupt. It was the financial sector, or more specifically, the banking sector. The collapse of the Korean economy was very similar to the Indonesian case. The people of Indonesia and Korea have suffered greatly. The Indonesian people have undergone hardship, such as, unemployment, poverty, ethnic conflicts, political instability, etc. What were the reasons behind the suffering of such a large number of people?

The weakness in the financial sector of Indonesia began to grow as a result of the reform of its banking system in June 1983, by liberalizing interest rates and by the complicated & selective credit policy with subsidized interest rates. In addition, the elements of the financial repression disappeared with the introduction of market liberalization in October 1988. Such reforms gave a severe impact on the Indonesian economy.

● The banking reforms have caused excessive credit expansion by the banking system because many financial institutions emerged with the removal of entry barriers.

● There was rapid increase in bank liabilities following the serious maturity and currency mismatches.

● The banks had poorly capitalized financial structure.

● The Indonesian government was heavily involved in a selection of credit customer. It distorted the economic principle and resulted in political corruption.

● There was a lack of prudent and credible administrative institutions or regulations. Indonesia lacked a sufficient financial infrastructure required to absorb the highly open and self-regulated banking system.

● The central bank, i.e., the Bank Indonesia, was not able to function as a competent lender to which companies could turned to as the last resort. Korea liberalized its financial sectors and opened the capital market without enough preparation required. However, the Korean economy basically did not have the strong financial basis, similar to the case of Indonesia

The purpose of my thesis is to study the factors that caused the Indonesian financial crisis, especially those related to the banking sector, and reforms which were adopted and are expected to direct the financial sector in playing a proper role in the national economy.

In particular, I would like to study the following issues:

● What is the current situation of the Indonesian banks?

● How did the Indonesian banks play a role in the preceding Indonesian foreign exchange and economic crisis.

● What roles played by the financial sectors are expected to help overcome the current economic difficulties and prevent the next economic crisis?

In conclusion, my ultimate goal is to find the direction for Korean banking sector, by examining the problems of the Indonesian banking sector and the expected reforms

2. Organization of the Thesis

The organization of the thesis is as followsL:

Chapter I will cover the purpose and overview of this thesis

Chapter II will examine the structure of the financial industry, monetary policy and the securities market. This chapter will focus on explaining the distinctive characteristics of the financial system and serial financial system reforms, which later triggered the financial crisis.

Chapter III will analyze the Indonesian financial crisis in connection with the problems of the financial system.

Chapter IV is the conclusion. In this chapter, I will review the thesis briefly and give my opinion on the core problems of the financial system in Indonesia and Korea.

Chapter II. Financial System in Indonesia

1. Structure of the Indonesian Banking Industry

a. The Banking System

The Indonesian banking system had incorporated a strict regulation on entry, interest rate, foreign exchange transaction, reserve requirements, establishment of branches, and so on. Some serial financial reforms, i.e., liberalization of interest rates, elimination of credit ceilings and introduction of indirect monetary instruments since 1983 had released a number of regulations. The Indonesian banking system can generally be divided into three parts, such as, the Bank Indonesia, state-owned banks and private commercial banks.

O The Bank Indonesia

The Bank Indonesia is the central bank of the Republic of Indonesia. The Bank Indonesia controls the overall financial system and has responsibility as being the lender of the last resort. Although the Ministry of Finance has authority to grant and revoke bank licenses, the Bank Indonesia has authority over the bank supervision and regulation. The Bank Indonesia has adopted a supervisory system similar to the U.S. CAMEL system (Capital adequacy, Asset quality, Management, and Liquidity) and annual on-site examination of banks. The major functions of the Bank Indonesia are as follows:

First, it controls the aggregate amount of liquidity and stability of the currency, the Rupia, through the reserve deposit.

Second, it endeavors to contribute in supporting the productivity and development of every economic sector.

Third, it supervises and regulates all the financial institutes except the insurance companies.

Fourth, it issues money and holds the official foreign reserve.

Lastly, it develops and implements monetary policies according to the decision of the Economic Stabilization Committee.

O The State-Owned Banks

The state-owned banks have been dominant players in the banking industry, though domestic private banks and joint venture banks with foreign banks have grown rapidly in recent years. Initially, business areas of state-owned banks were restricted to their traditionally specialized areas pursuant to the Bank Act of 1968. The Banking Act of 1968, which was replaced by the Banking Law of 1992, defined the major areas of concentration for each stated-owned bank. In practice, this restriction was not strictly implemented. The new banking law that was introduced in October of 1988 released a functional specialization for state-owned banks. In addition, the Bank Act No.7 of 1992 converted the state-owned banks to limited liability companies and allowed them to lend to non-priority sectors. Although the distinction has faded after the reform of the bank law, the seven state-owned banks consist of five sectarian banks, a developed bank and a savings bank. Specifically, they are, Bank BNI, Bank Dagang Negara(BDN), Bank Bumi Daya(BBD), Bank Rakyat Indonesia(BRI), Bank Ekspore Impore Indonesia(Bank Eksim), a development bank, Bank Pembanguman, and a saving bank, Bank Tabungan Negara(BTN). The state-owned banks possess a number of problems, such as, overstaff in-efficiencies and under-capitalization. Despite the fact that state-owned banks legitimately became private entities pursuant to the new bank law, the Ministry of Finance announced that no state-owned banks might default on its obligation under the government umbrella. In fact, the government still maintains the majority of the stockholders and intervenes in every function of the bank, especially in the decision process of fund distribution and personnel affairs. Such environment caused the state-owned banks to become morally hazardous and inefficient.

The main role of Bank BNI is to support the development project relating to industry, agriculture, transportation and export of domestic commodities.

Bank Dagang Negara(BDN) supports the mining industry and export industry

Bank Bumi Daya(BBD)'s specialty is to support the agriculture, forestry and plantation

Bank Rakyat Indonesia (BRI) is responsible for the development of rural areas and their residents.

Bank Ekspore Impor Indonesia (Bank Ekxim) is a specialized bank for international trade

The 27 province governments own the Regional Development Banks (RDB) that operates as the commercial bank or fiscal agent.

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❍ Private Banks

Indonesia has a very generous policy in establishing a financial institute. The banking industry reforms of 1988 lifted many restrictions. The policy of the low barrier to enter has resulted in a surprising increase in the number of banks. The number of banks reached about 240 in March 1994. Almost all of the large business conglomerates and many pension funds of state-owned companies have their own banks. Though Korea had a 2.5 times bigger scale of economy than that of Indonesia before the foreign exchange crisis in 1997, Korea now has only 26 banks. At present day, the Indonesian authorities place stricter limits on the granting of new license in order to stabilize the financial situation and to prevent newly established banks from going bankrupt. Commercial banks are not allowed to engage in securities undertaking, brokerage or trading. As a result, many banks established subsidiary companies to participate in the securities markets. The regulation to limit the extent of business areas of commercial banks precipitated the emergence of financial conglomerates.

There were 77 licensed foreign exchange banks as of December 1995. The requirements for domestic foreign exchange banks to open branch offices overseas have been relaxed. Twenty Indonesian foreign exchange banks have branch offices and representative offices in 14 foreign countries. All of these banks have off-shore banking units in the Cayman and the Cook island. The main operations of foreign exchange banks are presumed to be to launder obscure and illegitimate transactions of their customers at home.

Foreign banks can establish banks through a joint venture with local banks and the acquisition of shares of domestic banks that are floating in the stock market. The foreign banks may hold a maximum equity ownership of 80 percent. The only way for the foreign banks to do so is through a joint venture. The Indonesian authorities prohibited foreign banks from establishing wholly owned subsidiaries. In addition, the Indonesian authorities imposed a higher initial capital requirement on foreign banks compared to that of newly established domestic banks. The private national banks may open branch offices anywhere in Indonesia and the requirements for domestic foreign exchange banks to open branch offices overseas have been relaxed. However, foreign banks and joint venture banks whose operations were confined to activities conducted within Jakarta may still open sub-branches in seven other major areas. The main customers of joint venture banks and foreign banks are generally multinational companies from their own countries. The American companies are engaged in the natural resource sector while Japanese companies and ANIEs (Asian New

Industrializing Economics) are mainly related to non-oil manufacturing sectors. Many newly established joint venture banks are associated with the Japanese banks. The American banks have secured major customers and retail markets through their advanced technology, products and networks. One of the most important roles of foreign banks are, coordinating the private sectors' loans to Indonesian companies and government, and acting as a channel for obtaining assistance in official development from their respective governments and from multinational institutes.

There are about 8,000 villages or regional banks in Indonesia. These banks are Bank Perkeditan Rakyat (BPR), which may not even have branch networks nor issue demand deposits. Their asset portfolio, especially in deposit accounts, is severely limited. Accordingly, it is highly vulnerable to solvency. These banks represent an aspect of instability in the Indonesian financial system.

b. Characteristics of the Banking Industry

❍ Composition of the Banking System

The banking system holds a core position in the Indonesian financial system in terms of total assets and the number of offices. Although the NBFIs including securities companies, leasing companies, insurance companies and pension funds have grown rapidly in recent years, the banking system had held over 90 percent of the gross assets in the financial system in 1991.

Table 1.

Structure and Growth of the Financial Sectors, 1969-94

	Number			Shares in assets(%)			Assets growth		
	1982	1988	1994	1982	1988	1994	‘83-‘88	‘89-‘91	‘92-‘94
Bank Indonesia	1	1	1	42.4	36.8	21.3	18.8	9.2	6.6
Deposit Money Bank	118	111	240	52.8	56.8	78.7	22.4	32.6	37.4
NBFIs	113	202	n.a.	4.5	5.8	n.a.	30.1	33.6	n.a.
Others	5,808	5,783	n.a.	0.3	0.6	n.a.	33.4	15.9	n.a.
Total	6,040	6,097	241	100	100	100	21.2	21.3	29.0

Source: 1. Bank Indonesia, Indonesian Statistics and Annual Reports

2.Department of Finance, Statistics of the Finance Companies,1991

3.WIDER, Research for Action 27, The Banking System and Monetary Aggregates Following Financial Sector Reforms, Lesson from Indonesia, Anwar Nasution.

In particular, state-owned banks have held the largest portion in the banking system. Although the assets of private banks surpassed those of state-owned banks after the reform of the banking system in the 1990’s, the state-owned banks still maintain their dominant status in the Indonesian banking system

Table 2.

Market Share of Banking Institutes by Ownership

(unit: percentage of total)

	1988	1991	1993	1994	1995
Asset					
State-owned banks	63.0	45.2	41.8	38.7	36.9
Private Forex banks	16.0	29.4	34.8	38.7	39.6
Private Non-Forex banks	7.9	8.3	5.8	5.6	5.7

Joint Venture banks	5.1	7.8	8.4	8.7	8.8
Development banks	8.0	9.3	9.2	8.3	9.0
Loan					
State-owned banks	54.4	41.5	39.9	35.2	33.4
Private Forex banks	19.6	31.3	37.5	41.6	41.8
Private Non-Forex banks	11.1	9.5	6.8	6.0	6.3
Joint Venture banks	5.4	7.9	8.2	8.0	8.7
Development banks	9.5	9.8	8.6	9.1	9.8
Saving & Time Deposits					
State-owned banks	58.7	42.6	39.9	34.7	33.2
Private Forex banks	21.3	37.3	41.7	46.7	49.2
Private Non-Forex banks	12.5	12.8	9.9	9.0	7.7
Joint Venture banks	3.7	2.9	1.8	2.6	2.2
Development banks	3.8	4.4	6.7	7.0	7.7
	1988	1991	1993	1994	1995
Demand Deposits					
State-owned banks	54.3	38.3	32.3	31.1	32.4
Private Forex banks	17.4	34.5	43.2	43.1	43.7
Private Non-Forex banks	12.0	11.9	8.2	7.7	7.3
Joint Venture banks	4.3	3.9	5.5	4.5	4.8
Development banks	12.0	11.5	10.8	13.6	11.8
Total Deposits					
State-owned banks	57.5	41.5	38.3	33.9	33.0
Private Forex banks	20.2	36.6	42.0	45.9	48.1
Private Non-Forex banks	12.4	12.6	9.5	8.7	7.6
Joint Venture banks	3.8	3.1	2.6	3.0	2.8
Development banks	6.1	6.1	7.6	8.5	8.5

Notes: 1. Some non-foreign exchange banks became foreign exchange banks in this period

2. The state-owned Bapindo is included in the category of Development banks

Sources: 1. Bank Indonesia, Indonesian Financial Statistics.

2. WIDER, Research for Action 27, The Banking System and Monetary Aggregates Following Financial Sector Reforms, Lesson from Indonesia,

The Indonesian financial authorities have implemented various financial reforms since 1983 for the purpose of lifting the numerous restrictions on the banking system. There were no competent or prudent supervisory institutes, nor a sound system, which could have brought a healthy development of the banking system. To be specific, the Indonesian financial system had not been equipped with a sound infrastructure to digest advanced reforms.

The banking sector had to lower the credit standard due to severe competition provoked by the deregulation and continued to operate on the basis of the already outdated principles under the previous financial repression. Their valuation practices were mainly based on the historical book records instead of market value or quality of collateral. Credit risks and interest risk were not sufficiently considered.

Banking regulation and supervision were enforced, which generally focused on judicial compliance rather than on risk evaluation of individual banks. A more restrictive CAMEL (Capital adequacy, Asset quality, Management, Earning, Liquidity) system and annual on-site examination of banks for regulating and supervising were introduced in February 1991, i.e., after more than 2 years since the introduction of the drastic banking reforms in October 1988. Above all, these problems imply that lending limits were abolished without any safety measures. As a result, the fragile infrastructure caused a huge amount of NPLs (Non-Performing Loans) of banks. The NPLs problem of state-owned banks was at a serious level. It can be shown by the recovery case of Bapindo, which had built-up overwhelming percentage of NPLs.

Table 3.

Commercial Banks' Non-Performing Loans, 1993-95

(unit: percent of total credit)

	1993	1994	1995
All banks(%)			
Non-performing	14.2	12.1	10.4
Bad	3.3	4.0	3.3
State-owned banks			
Non-performing	19.8	18.6	16.6
Bad	4.0	5.9	5.3
Private banks			
Non-performing	7.3	5.4	4.9
Bad	2.1	1.9	1.4
Total Credit(trillion Rupia)	177.5	217.0	267.8
State-owned banks	99.1	101.1	120.9
Private banks	79.8	108.5	141.3

Note: 1. Bad loans are the lowest quality of the three categories of non-performing loans, which are sub-standard, doubtful and loss

Source: 1. Bank Indonesia, World Bank
2. IMF Working Paper, The Indonesian Financial System, John Montgomery

Under-capitalization of banks and non-compliance with certain important rules demonstrate further serious problems of the Indonesian banking system. The Indonesian financial authorities were not able to improve nor forcefully and consistently implement their policies due to without necessary regulation regarding under-capitalization of banks.

Table 4.

Number of Banks in Non-Compliance with Prudential Rules, 1995

	Total number in category	Capital adequacy ratio	Legal lending limit	Loan-deposit ratio
State-owned banks	7	0	2	1
Private banks	166	18	56	11
Local development banks	27	2	3	0
Joint venture banks	40	1	9	6
	240	21	70	18

Source: Bank Indonesia, reported in "banks suffer U$4.5bn in bad loans, Indonesian Observer, January 26,1996, and Report of the Financial Year 1994/95.

Most large banks are closely connected to the Indonesian private conglomerates. This situation has produced many problems for a long period of time. These banks are not able to evaluate their sister companies on a commercial basis. It also caused a moral hazard for both banks and their sister companies, enabling the raising of funds without much effort.

O Inefficiencies in the Banking System

The Indonesian banking system had been comprised of many under-capitalized banks since the serial-banking reforms were enacted in 1980's, because many initial obligations required for the establishment had been lifted. This resulted in the emergence of a number of problems which adversely affected the efficiency of the banking system

First, the under-capitalized banks tend to pursue high yield and high -risk assets since they are unable to raise funds with low cost. Furthermore, even if they fail to indemnify their liabilities, the government gives an implicit guarantee of protection. There is no incentive for undercapitalized banks, especially state-owned banks, to adopt an optimal and safe lending decision. As a result, many Indonesian banks are under a heavy burden of non-performing loans due to their hasty lending policy.

Second, the undercapitalized banks are very unstable and in a vulnerable position against exogenous variables. Such circumstance restrains monetary policies from being implemented for controlling the aggregate liquidity and the foreign short-term capital inflow due to banks with poor domestic capital. If the monetary authority wishes to raise the reserve requirement level with intention to decrease the aggregate liquidity, the under-capitalized banks should decrease their liabilities as well as their high yield and high-risk assets. The under-capitalized bank may experience a dilemma because their soundness was exacerbated in addition to the fact that they must meet the 8% capital adequacy ratio.

The unique ownership structure of the Indonesian banks has impaired the efficiency of the banking system. Under the Banking Act No of 1992, state-owned banks have been converted to limited liability companies. To be certain, however, the state-owned banks are still state enterprises. The government intervenes to allocate loan assets, in order that it mitigate the responsibilities of state-owned banks. This may bring a moral hazard in addition to an inefficient use of valuable funds. The state-owned banks hold a huge amount of non-performing loans compared to private banks. On the other hand, many big private banks are owned by affiliates of large conglomerates. Such situation has also distorted the financial efficiency of the Indonesian banking system. The banks are not interested in maximizing returns for them but rather in the gain and loss by the owners of the conglomerates. Furthermore, they frequently violate the permissible limit for lending in order to support their sister companies. The permissible limit for lending refers to an exposure to an individual borrower that is below 20 percent of the capital. In addition, the aggregate of the total exposure to all affiliated entities must not exceed 10 percent of the capital.

The application of the relevant Indonesian laws to the financial system has aggravated the efficiency of the banking system. There are many aspects of law that may render certain issues illegal in the Indonesian financial system. The most obvious are collateral laws, which do not provide adequate frameworks for corporate restructuring and do not guarantee repayment through disposal of their collateral when borrowers go bankrupt. Loan officers of banks are not able to make rational decisions that bring the highest economic returns, so they focus on the borrower's political background rather than on the borrower's collateral or credit evaluation under the unreasonable legal system.

In some occasions, the government forces the state-owned banks to lend huge amount of funds to strategically targeted industries, such as, the aircraft industry, automobile industry, and etc., without considering any economic factors. The state-owned banks are also compelled to lend funds to remotely appropriate corporates that are deeply involved with politicians.

O Stability of the Banking System

The banking industry is a core sector of the national economy. The bankruptcy of the bank may result in massive disasters which may drastically damage the financial stability. Most Asian people have recognized the significance of financial stability through experiencing the Asian foreign exchange crisis in 1997. There are many factors, which may work as catalysts to trigger a serious crisis in the banking system. There is a systematic risk that exists in the banking system. One may ask whether there is any possibility that banks default on their liabilities. There is indeed such a possibility, as evidenced from what we have seen in many cases. However, this depends mainly on the government policy as well as on the legal system. If so, one may also ask whether there is any possibility that such bank's default will cause other banks to default on liabilities of their own. Likewise, a failure by one bank may induce bank runs on other banks. A bank's default, which depends on the governmental policy, may be cured by the central bank, which is considered as a lender of last resorts.

What are the potential sources that trigger banks to go bankrupt in the Indonesian banking system? There are a number of factors which may lead to a disaster. The few obvious ones are as follows:

First, most Indonesian banks prefer 'property lending'. This refers to the banks' lending to property developers, producers of construction materials and borrowers whose creditworthiness depends on assets, such as, real estate. If the economic cycle reaches the depression phase or if the bubble of overvalued real estate bursts, the borrowers and lenders will immediately go bankrupt.

Second, no one is able to perceive the true situation of Indonesian banks due to the lack of transparency of the bank's balance sheets. In other words, the value of banks may be over-stated compared to its true value through technical restructuring which may obscure the poor quality assets.

The Indonesian financial authorities have tried to prevent such potential risks by applying a series of remedies

First, the authorities had attempted to strengthen the bank's capitalization by borrowing US$ 307 million in Financial Sector Development Project Loan from the World Bank on November 12, 1994 or by granting a government guarantee to banks in order that they may raise funds from the international market.

Second, the authorities have encouraged the merging of weak banks into strong banks through various inducements, such as, favorable tax treatment, foreign exchange license, and etc. However, the policy of merging troubled banks has brought a substantial risk of bank failure on other banks.

Third, the authorities have tried to accommodate good financial infrastructures, which may bring a high level of transparency of bank balance sheets through the CAMEL system, i.e., an annual on-site examination of banks by Bank Indonesia.

One crucial issue that has been disregarded is the ALM (Asset Liability Management). Generally, banks borrow funds on a short-term basis and lend funds on a long-term basis. This showed that such mismatch could be a critical problem during the financial crisis period. However, such fact has continuously been ignored since the banks pay lower costs for short-term funding and earn higher profits for long-term loans.

The stability of the banking system is easily affected by macroeconomic shocks, such as, the exchange rate or interest rate shocks. The aggregate of foreign currency denominated assets and liabilities of Indonesian banks have increased rapidly in recent years. Bank Indonesia limits its net foreign exchange exposure to 25 percent of the bank capital. In reality, the restriction is almost ineffective since the valuation of foreign exchange exposure is very difficult. In particular, the assets related exchange rate option written by banks and the low net exposure might work large gross exposure. In fact, Indonesian banks have a huge amount of foreign currency denominated loans, which are financed by the foreign currency deposits rather than their equity capital. If the Rupiah loses its value massively, serious difficulties will arise and any large default on foreign currency loans can depreciate the equity capital of banks.

The increase in interest rates may perturb the bank’s stability. As the interest rates increase, non-performing loans will also increase because of the higher interest burden on borrowers. Meanwhile, the aggregate demand will decrease and the business profitability will be reduced.

Another risk that emerged in recent years is the risk of derivative exposure. Under the relevant regulation, the bank’s derivative exposure is limited only to the extent of its interest rates and exchange rates, in addition to the fact that the potential losses may not exceed 10 percent of the bank capital. However, Bank Indonesia's control of the derivative exposure is also a doubtful measure since the valuation of derivatives is a very complicated task.

Table 5.

On Balance –Sheet Bank Foreign Exposure, 1990/91-1994/95

(unit: trillion of Rupia)

	1990/91	1991/92	1992/93	1993/94	1994/95
Current foreign exchange Liability	29.2	31.4	44.7	57.3	62.5
Outstanding foreign exchange Credit	12.3	19.3	23.2	30.4	38.9
Equity capital	11.9	10.9	13.4	19.8	23.0
Foreign exchange liability/ Equity capital(%)	246	288	334	289	271
Foreign exchange credits/ Equity capital(%)	104	177	173	153	169
Net foreign exchange credits/ Equity capital(%)	143	111	161	136	102

Source: 1. Bank Indonesia, Indonesian Financial statistics, 1996
2. IMF Working Paper, The Indonesian Financial System, John Montgomery, April 1997

C. Financial Deepening

Problems in the Indonesian financial sector have deepened with speed after a series of financial reforms that have been in force since 1983. However, development is not at a satisfactory level compared to that of neighboring countries. Ratios of M1/GDP, M2/GDP, and TAFI/GDP have risen substantially since the 1980's. This suggests that the circulation speed and the use of money increased as a result of credit creation via financial institutes. There are a number of distinctive characteristics related to the financial deepening of the Indonesian economy.

First, the ratio of the stock market value against the GDP rose rapidly.

Second, the proportion of the US Dollar deposit and the share of the banks' credit denominated in US Dollar of the total credit at commercial banks increased quickly and reached an apprehensive level. Because of the weak Indonesian economy and the Rupia, the increase in the amount of conversions of the Rupia to the US Dollar have made the interest rate become more easily alterable by the international interest rate. Such phenomenon has been proven to be a substantially dangerous factor to the Indonesian economy during the foreign exchange crisis period.

Table 6

Size of the Financial Sector in Southeast Asia, 1989-94

(unit: in percent of GDP)

	1989	1990	1991	1992	1993	1994
Bank Assets						
Indonesia	49.3	60.5	64.2	63.0	58.8	57.3
Malaysia	92.4	96.0	101.9	95.0	92.9	99.9
Thailand	72.7	79.2	82.2	85.0	94.6	109.5
Bond Outstanding						
Indonesia	2.7	1.6	5.5	8.9	9.2	5.8
Malaysia	66.1	66.3	60.6	55.2	54.5	56.1
Thailand	11.5	9.9	8.1	7.6	8.2	9.8

Equity Market Capitalization						
Indonesia	2.4	7.6	5.8	9.4	22.8	30.2
Malaysia	105.0	113.6	124.4	162.1	162.1	282.7
Thailand	35.5	27.9	36.3	52.0	52.0	94.0

Source: International Financial Corporation, Emerging Stock Markets Factbook
International Monetary Fund, International Financial Statistics, World book,. The Emerging Asian Bond Market.

Table 7

Financial Deepening of Indonesian Economy

(unit: %)

	1988	1991	1994
M1/GDP	0.10	0.12	0.14
M2/GDP	0.3	0.44	0.55
TAFI/GDP	0.81	0.96	1.01
U$ deposits/M2	15.5	21.3	17.8
U$ deposits/total credits	4.1	15.6	18.3

Source: 1. Bank Indonesia, Indonesian Financial Statistics and Annual Reports
2. WIDER, Research for Action 27, The banking system and Monetary Aggregates Following Financial Sector Reform, Anwar Nasution,1996

Note: 1. M1 (narrow money) includes currency, coins, demand or checking deposits and other current deposits which are highly liquid
2. M2 (broad money) is equal to M1 plus the less liquid savings and time deposits, money market mutual fund shares available for individuals, overnight repurchase agreement and foreign exchange deposits
3. TAFI is the total asset of financial institutes

2. The Indonesian Monetary Policy

a. Basic Principle

The Indonesian economy has been oriented to a more market-based monetary system. Among other things, the entrance barrier against the financial industry was lowered, many capital controls were removed and a more flexible exchange rate system was adopted. As a result, the competition level increased in the financial market and the domestic financial market became more integrated with the international market. Such changes show that the stability of the financial structure has been shaken by the emergence of the countless financial institutes including unstable ones and that the independence of the monetary policy has been disturbed to a considerable extent, to the effect that the magnitude of the risk on the Indonesian economy has increased.

The financial authorities adopted a more restrictive CAMEL(Capital adequacy, Asset quality, Management, Earnings, Liquidity) system to regulate and to supervise banks. The capital adequacy ratio of 8 percent was imposed on the banks. The authorities also introduced new standard accounting and reporting system for banks.

b. Reforms in the Financial System

Table 8

Reform in the Banking Industry in Indonesia, 1983-1995

Policy Measures	Before reform	After reform	Date
I. Competitive Measure			
1. Entry of new banks			
(a)Private banks	Closed since 1970	Permitted	1988.10
(b)Foreign banks	Closed since 1970	Permitted	1988.10

2. Branching power (a)Private banks (b)Foreign banks	 Restricted 1) Restricted to Jakarta	 Permitted to Sound banks Permitted to Seven cities	 1988.10 1998.10
3. Foreign exchange License	Restricted 1)	Eligible for Sound banks	1988.10
4. Type of loans (a) State banks (a)Private banks (b)Foreign banks	 Mainly the extended subsidized credit programs, as set and refinanced by Bank Indonesia Free to set Free to set	 The scope and coverage of the subsidized credit program reduced 20% total credit must be extended to small business 2) 50% total credit must be extended to export related active	 1983. 6 1988.10 1988.10
5. Types of loans (a) State banks (a)Private banks (b)Foreign banks	 Set by Bank Indonesia Free to set Free to set	 Free to set Free to set Free to set	 1983. 6
6. Deposits of public sector	Restricted to state Banks	Restricted to state Banks	1988.10
7. deposits of state enterprise	Restricted to state Banks	Up to 50% with Private banks	1988.10

8. deposit rate (a) State banks (a)Private banks (b)Foreign banks	 Set by Bank Indonesia Free to set Free to set	 Free to set Free to set Free to set	 1983. 6
9. Loan rate (a) State banks (b)Private banks (c)Foreign banks	 Controlled by Bank Indonesia Free to set Free to set	 Free to set Free to set Free to set	 1983. 6
10. credit ceiling (a) State banks (a)Private banks (b)Foreign banks	 Set by Bank Indonesia Set by Bank Indonesia Set by Bank Indonesia	 Eliminated Eliminated Eliminated	 1983. 6 1983. 6 1983. 6
11. Foreign exchange power(limited to licensed banks)	Subjected to ceilings set by Bank Indonesia	Net open position 3)	1989.11
12. reserve requirements	15% of deposits (differentiated between banks)	2% of deposits	1988.10

13. entry to new activity			1988.12
(a)Leasing	Not regulated	Subsidiary	4)
(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) 5)	-	Prohibited	
(h)Custodian	Not regulated	Approval required for capital market	
(i)Trustee and guarantor	Not regulated	Approval required for capital market	
(j)Securities administrative agency	Not regulated	Prohibited	
(k)Investment Manager	Not regulated	Subsidiaries	
II. Prudential Measures			
1. Capital requirements			
a)Private banks	-	Rp. 10bn	1988.10
		Rp. 50bn	1992.10
(b)Foreign banks (min. 15% domestic ownership)	-	Rp. 50bn	1988.10
		Rp.100bn	1992.10
(c)Bank Perkreditan Rayat	-	Rp. 50bn	1988.10

<table>
<tr><td rowspan="4">2. Legal lending limit</td><td rowspan="4">None</td><td colspan="2">1.Old credit(% of bank capital)</td><td rowspan="4">1993. 5

1993. 5
1995.12
1997. 3</td></tr>
<tr><td>Indivi.</td><td>Group</td></tr>
<tr><td>20%
20%
20%</td><td>50%
50%
50%</td></tr>
<tr><td colspan="2">2. New credit
20% of for indivi. & group</td></tr>
<tr><td>3. Loan to deposit ratio</td><td>None</td><td colspan="2">110%</td><td>1991. 2
6)</td></tr>
<tr><td>4. Capital adequacy Ratio</td><td>None</td><td colspan="2">(% of risk weighted assets)
5% by Mar.1992
7% by Mar. 1993
8% by Dec. 1993
7)</td><td>1991. 2</td></tr>
<tr><td>5. Net open position</td><td>None</td><td colspan="2">25% of capital</td><td>1989. 3</td></tr>
<tr><td>6. Accounting standard</td><td>None</td><td colspan="2">Standardized 8)</td><td>1993. 1</td></tr>
<tr><td colspan="5">III. Money market</td></tr>
<tr><td colspan="5">Reintroduced in February 1984, SBI is the most important money market instrument at present. On June 1, 1993, the auction system of SBI changed from “cut-off rate”(COR) to “stop-out”(SOR). The private sector commercial paper(SBPU) introduced in January, 1985. Until now, the government has not floated treasury bonds in domestic market.</td></tr>
<tr><td colspan="5">IV. Transparency and accountability of reporting and management</td></tr>
</table>

1. To improve banking supervision by (I) standardizing accounting and reporting system (ii) requiring commercial bank to submit detailed business plans to the central bank and beginning person involved in fraudulent transaction 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 (I)submit detailed credit recovery plans (ii)standardize internal audit system and (iii)adopt standardized information system technology.

Notes:

1) Permitted in principal, but economic and social requirements made it prohibited in practice.
2) Since May 29, can be channeled through other banks and BRPs.
3) Overseas borrowing for public sector is subject to ceilings set by TKPLLN(Coordinating Team for Management of Commercial Offshore Loans) since October 1991.
4) Item (g) to (j) are subject to Ministry of Finance's Decisions No. 1548 of 4 December 1990.
5) Can underwrite bonds and other debt instruments.
6) Since May 29, 1993, own capital included in the denominator.
7) In May 29, 1993, this schedule was extended to December 1994.
8) Standardized - Standar Khusus Akuntansi
   SKAPI(Perbankan Indonesia) – Accounting Standard for Indonesian Banks

Sources.:

1) Pakto 1988, Pakmar 1988, Pakjan 1990, Pakfeb 1991, Banking Law Number 7, 1992: Banking Regulation, May 29,1993
2) Nasution, Anwar, "Financial Institution and Policies in Indonesia" Singapore: ISEAS(1983)
3) David Cole and Betty F. Slade, " Development of Money Markets in Indonesia", Development Discussion Paper No.371, Cambridge, MA: Harvard University, HIID, in January 1991.

4) John Chant and Mari Pangestu, “An Assessment of Financial Reform in Indonesia: 1983-90” in G.Caprio, Jr. et. Al., Financial Reform: Theory and Experience, mimeo, 1992.

c. Liberalization of Foreign Capital Inflow

The Indonesian government has implemented two controversial policies regarding foreign capital inflow.

First, the Indonesian government has pursued a balance budget policy. As a result, the government did not wish to bring a budget deficit or to offset the government budget deficit by borrowing foreign capital. Instead, the government tried to offset the budget deficit by way of concessionaire foreign aid and loans from the Western official creditors. It was not difficult for the Indonesian government to draw an official proceed because Indonesia had held a substantial political and diplomatic power for a long time. The Indonesian government has strictly regulated the public sectors from obtaining foreign loans (including local government, quasi-government and state-owned enterprises) and required approvals from the Ministry of Finance as well as the Planning Agency (Bappenas-Badan Perencaan Pembangunan Nasional). The Bappenas controls the allocation of the expenditures for development in the state budget and the Ministry of Finance governs the allocation of the routine budget.

Second, the Indonesian government has attempted to attract more foreign capital, especially from direct investment by foreign entities. Although the saving rate of Indonesia has been maintained at a relatively high level for the past several decades, the investment rate has always surpassed the saving rate due to the fact that the Indonesian government had pursued and achieved high economic growth during the period. Thus, Indonesia has always maintained a current account deficit. The Indonesian government had hoped for a foreign capital inflow, which would offset the current account deficit, as well as augment and stimulate economic growth. Foreign capital inflow in the private sector was regulated in a relatively less severe manner for the purpose of inducing foreign capital. The government had in fact helped the private sector borrow foreign proceeds at a special exchange rate and with the exchange rate swap facility assisted by the government, which provided a forward cover.

Furthermore, the Indonesian government lifted a number of restrictions on foreign capital inflow in order to attract more foreign capital. The reforms eased the requirements on the foreign exchange transaction for domestic banks and opened in considerable scope the domestic economy to foreign banks.

The new rules and regulations replaced the ceiling on the offshore borrowing by commercial banks through a system of net open position, and also abolished the limit for the inflow of FDI in November 1988. The NOP regulation requires commercial banks to maintain long and short positions of foreign currencies with 20 percent of their equities. The short-term foreign capital inflow in the private sector (especially commercial banks) increased very rapidly because the commercial banks generally take portfolio with short-term borrowing and long-term lending. The large-scale foreign capital inflow in the short-term-private sector as a result of the reforms played a role in bringing about the rapid credit extension and inflation. The increase in the short-term foreign currency liabilities lowered the mobility and vitality of the economy.

The authorities imposed a special quantitative ceiling on offshore borrowing by the public sector (including state-owned enterprises) to decrease the short-term foreign capital inflow in October 1991. The ceiling is also imposed on offshore borrowing by the private sector which rely on public institutes for raising their funds. But the quantitative ceilings on foreign capital inflow were not considered adequate in terms of efficiency because the system inevitably brought the rationing of the limited quantity based on a method irrelevant to price. (e.g., political favors)

The Bank Indonesia eliminated the exchange rate swap, which is perceived as an implicit subsidy of short-term foreign capital inflow.

Despite the reforms to restrict short-term foreign capital inflow and to control external borrowing, there are substantial loopholes. The exceptions in the restrictions are long-term economic infrastructure projects (including electric generating plants, telecommunications, toll roads) and industries substituting import (including strategic industries), which are designated by the Ministry of Research and Technology. The designated strategic industries are aircraft (PT IPTN), steel mills (PT Krakatau Steel), shipyard (PT PAC), diesel engines (PT oma Bisma Indra), heavy equipment (PT Barata), electronics (PT LEN), telecommunication equipment (PT INTI), light armaments (PT Pindard), locomotive and railway tracks and wagons (PT INKA). Such industries represent an ambitious plan by the Indonesian government that fosters strategically industries that are considered that necessary for Indonesia to become a developed country by sacrificing an important monetary policy. Unfortunately, the Indonesian economy was not equipped with basic fundamentals to comply with the policy.

First, there was no incentive for strategic industries to promote quality, efficiency, marketability, or etc., because of the government's protection or guarantee for monopoly or oligopoly status.

Second, the pilot companies taken strategic industries were not competitive companies but politically involved private enterprises. Basically, these kinds of firms are not capable of producing high quality commodities or service.

Lastly, the development in the Indonesian economy did not reach the level high enough to be on track with the high technology industries and there was no domestic market capable of upholding the industries

The Indonesian monetary authorities were not able to succeed in controlling foreign debts or in decreasing short-term foreign capital inflow due to the unreasonable exception policies. The total amount of Indonesian foreign debts surpassed US$130 billion, which contributed, to the foreign exchange crisis in 1997. Such exceptions, which had deviated from the basic principle, became one of the main causes of the national disaster.

d. Interest Rate Policies

The interest rate, which consists of the deposit interest rate and the lending interest rate, is one of the most important factors that affect the bank's profit level. The gap between the deposit interest rate and the lending interest rate is the deciding factor for the bank's profits. The interest rate is decided by the conditions of the money market, e.g., demand and supply of money or the inflation rate since the interest rate is the opportunity cost for holding the money in addition to being the expectation money value of the future. The liberalization of the interest rate may be regarded as the first step to the liberalization of financial sectors.

The reforms in 1983 endowed the Indonesian banks with full autonomy in deciding the interest rate according to the money market condition from the complicated ceiling as a result of a selective credit policy and from the repressed credit system involving subsidized interest rates. The following serial financial reforms also removed the external barrier in the financial market. The external deregulation increased the capital mobility and sensitivity for the international interest rate.

These reforms caused serious problems:

First, the monetary policy of the government was limited and became complicated because of the close correlation between the interest rate and exchange rate. As a result, the authorities had to intervene in the foreign exchange market in order to control the interest rate.

Second, the Indonesian financial authorities adopted the CAMEL system to regulate and to supervise the banking system. Generally, undercapitalized Indonesian banks faced serious problems because the banks could not take high risk and high return assets due to CAR.

3. The Indonesian Securities Market

a. Stock Market

The Jakarta Stock Market Exchange (JSE) was reopened in 1977 as part of a capital market supervisory agency (Bapepan) under the Ministry of Finance. The JSE was separated from the Bapepan and was privatized on December 4,1991. The Surabaya Stock Exchange (SSE) was established on March 30,1989. The Bapepan has a simplified listing procedure and a trading system in the Indonesian stock exchange. The Jakarta Stock Exchange introduced a centralized settlement system for all listed securities in June 1994.

The Indonesian Stock market has expanded rapidly in recent years due to the development of the market infrastructure, expansion of domestic and foreign investor base and improvement in the regulation and supervision in the securities market. However, the Indonesian stock market is still relatively underdeveloped compared to that of the neighboring countries as stated in Table 6. To achieve sound and rapid development, the Indonesian stock market must promote transparency and fairness in the market, such as, prohibition of insider trading.

There is favorable prospect in the Indonesian stock market since the institutional investors are rapidly expanding and many companies are willing to shift their funding from bank credit to self-financing, such as, issuing stocks and bonds.

b. Bond Market

The Indonesian bond market was in its infancy prior to 1984. There were no government bonds in Indonesia as the Indonesian government had pursued a balanced budget and had offset the deficit through the foreign official assistance program.

The capability of the government to control domestic interest rate was weakened after the government relaxed controls on bank credit and interest rates because the foreign capital movement became interest-rate sensitive. The financial authorities had strong incentive to foster the money market to sterilize foreign capital inflow. Bank Indonesia issued the SBI (Sertificat Bank Indonesia), its certificate, in order to sterilize the effects of foreign capital inflow. The SBI is the most important money market instrument in Indonesia. The private sector commercial paper (SBPU-Surat Berharga Pasar Uang) was introduced in 1985. It also proved as an ineffective instrument. But the money market of Indonesia did not develop enough to meet the governmental monetary objectives because the Indonesian money market was very shallow and narrow. The authorities had no choice but to use a non-market mechanism. Professor Mr. Sumalin, the Minister of Development Planning and Acting Minister of Finance, instructed a number of large state-owned companies to convert Rp900billion of their deposit, mainly in state-owned banks, into SBI in July 1989. The second 'Sumalin shock', was introduced in February 1991 when Mr. Sumalin became the Minister of Finance. He implemented a withdrawal of Rp7 to Rp 8trillion(US$ 3.64billion to US$ 4billion at the time) from the monetary base. The withdrawal amount was nearly half the stock of M1. The financial authorities restored their autonomy of the monetary policy through high cost expenses.

Many private non-financial companies have tried to raise funds by issuing bond and commercial paper. To meet the monetary market situation, PT Pefindo(Pemeringkat Ef Indonesia), a private rating company, was established in 1995. The size and participants of the money market have been increasing in recent years. The secondary market for bonds is still inactive because pension funds and insurance companies have held the issued bonds until the maturity date.

The market is expected to be more active in the near future as many large state and private companies try to diversify the funding source from banks to various financial instruments

c. Institutional Investors

The necessary precondition for capital market development is the growth of institutional investors as mutual funds, insurance companies and pension funds to channel individual saving into capital market. The Indonesian institutional investors are still in its initial development stage. The Bapepan permitted institutional investors to invest a maximum of 85% of net assets in the stock market. Though pension funds developed rapidly, they invested 85% of their assets in bank deposit. The investment of institutional investors is not at a satisfactory level yet. The high real returns and safety is required in order to induce the institutional investors to invest their assets into capital market.

Chapter III. The Indonesian Financial Crisis

1. Background of the Indonesian Financial Crisis

There are many factors caused the Indonesian financial crisis. Some people believed that the financial crisis occurred suddenly without a distinctive hint by international conspiracy. Such an allegation is very controversial. However, it is not difficult to find many symptoms that triggered the financial crisis. The most important thesis on the Indonesian financial crisis is that Indonesia did not have enough foreign reserve to repay its debt. Namely, Indonesia did not earn enough foreign reserve.

The international market was very unfavorable to Indonesia.

First, the competition in the labor-intensive commodity exports became very severe.

Second, the export from China, which is a strong competitor for the Indonesian labor-intensive export industry, increased rapidly as the Yuan of China devalued about 50 percent in January 1994.

Third, the price of crude oil, one of the most important income sources, dropped severely.

The price competitiveness of the Indonesian export commodities was weakened by appreciation of the Rupia because the appreciation of US dollar to Japanese Yen raised Rupia's value, which was connected with US dollar's value.

The Indonesian private sector excessively financed offshore borrowing after serial reforms in 1983.

Especially excessive short-term foreign debt became a dangerous catalyst and excessive foreign capital inflow raised the Rupia's value extraordinarily, which exacerbated the price competitiveness of the Indonesian export industry.

The Indonesian politics, which had maintained its stability for several decades under the rules of Mr. Suharto began to tremble as Mr. Suharto aged. The severe forest fire and the long draught caused by the El Nino decreased about 10% of the rice production and raised the consumer's price level profoundly. The strong leadership to overcome the crisis had already disappeared.

Table 1.

Key Indicators of Indonesian Economy: 1990-1996

(In percent of GDP)

	1991	1992	1993	1994	1995	1996
nternal Stability						
GDP(growth rate)	8.9	7.2	7.3	7.5	8.1	7.8
Saving rate	26.9	26.9	27.0	28.4	28.0	29.3
Investment	29.9	29.0	28.3	30.3	31.3	32.7
Inflation(CPI)	7.7	7.8	7.4	6.3	5.5	5.3
Fiscal balance	0.4	0.4	-0.4	0.1	0.8	0.2
xternal Stability						
Current Account Balance	-3.7	-2.2	-1.6	-1.7	-3.6	-3.7
Net capital Inflow	5.0	3.8	1.7	2.0	4.3	5.0
Reserve(in months of imports)	4.8	5.0	5.2	5.0	4.4	5.1
Short term debt(U$ billion)	14.3	18.4	18.0	17.1	24.3	29.3
Debt Service Ratio	32.0	31.6	33.8	30.0	33.7	33.0
Exports of goods(% of growth)	13.5	16.6	8.4	8.8	13.4	9.7

Sources: IMF, International Financial Statistics.
IMF, Annual Report, 1996 and 1997.
World Bank, World Debt Tables: External Finance for Developing Countries 1996.
World Bank, World Development Indicators.

2. Causes of the Indonesian Financial Crisis

a. Macroeconomic Policy

O Exchange Rate Policy

The exchange rate system with the intervention band has played an important role in the Indonesian financial crisis. The exchange rate has a significant impact on exports because it is one of the crucial determining factors of international competitiveness.

The Indonesian exchange rate policy has always carefully managed a reasonable devaluation of the Rupia to maintain external competitiveness. The authorities devalued the Rupia by 50% compared to the US dollar and replaced the US dollar as its external anchor with the managed floating exchange rate system. The weight of the US dollar in the currency basket remained substantially under the managed floating exchange rate system. The monetary authorities have basically pursued the devaluation of the Rupia by 3 to 5percent annually.

The Indonesian monetary authorities faced the need of an adjustment in the exchange rate system because the Indonesian economy, mired in dilemma, began to fall apart. The Rupia was appreciated in the mid-1990s as strong the US dollar which was Rupia's main external anchor. The exchange rate of the Japanese Yen to the US dollar shifted from 85 in 1995 to 127 in 1997. This change weakened the external competitiveness of the Indonesian export industry. It destroyed the efficient decision of saving and investment, and thus the valuable scarce saving was wasted on unproductive investment projects. At this juncture, the monetary authorities should have selected the floating exchange rate system or widened the managing floating exchange rate system. This move resulted in a considerable amount of current account deficit. Although the authorities were aware of the need for change in the Indonesian exchange system, they were unable to opt for the alternative, which was sure to bring on high inflation and increase of unemployment. As a result, the Indonesian economy faced disaster and gave up the exchange rate system with narrow width of adjustment.

∓ Foreign Debt

The Indonesian economy faced a financial crisis and collapsed languidly in 1997. What was the most fundamental cause? One of the most important factors was excessive foreign debt, which surpassed the control capability of the relatively small Indonesian economy. The total amount of external Indonesian debt was U$ 134billion. This was two thirds of GDP and twice the export value in 1997. This meant that the Indonesian economy became very fragile against unfavorable external changes and was on the verge of collapse. The Indonesian government implemented high economic growth policy and eased the restriction of foreign capital inflow because they wanted foreign capital and advanced technology to help its economic development. The Western capital was also eager to find a profitable market, which guaranteed a high and safe yield. For the West, Indonesia showed promises of profitable investment as Indonesia was known for a high economic growth for several decades under the stable rule of President Suharto.

The short-term loan was about US$ 68billion in 1997 and most of the short external debt (US$ 49.3billion) was borrowed from foreign banks. The tenure of US$ 30billion foreign debt was less than one year. The average maturity of the short-term external debt (US$ 67billion) was about 1.5years. This appeared as a serious problem during the foreign exchange crisis and triggered the collapse of the Indonesian economy. The private sector's borrowing has increased rapidly in the 1990's. Over two-thirds of the bank loans (US$ 33billion) was borrowed by the non-financial private sector. Most of the private sector's external debt was for economic infrastructure projects, which were owned by politically, connected conglomerates, and received implicit and explicit guarantee of the government.

The Indonesian government has tried to control the external debt but the attempts have proved ineffective. Indonesia established a connecting system to obtain and use the ceiling, and abolished the implicit subsidy on the premium of exchange rate swap facility, which was implemented to induce foreign capital inflow.

∓ Current Account Deficit

There are many common characteristics among Indonesia, Mexico, Brazil and Russia.

First, these countries have abundant natural resources, and therefore yield a considerable trade surplus every year.

Second, they had plans to join the ranks of the advanced countries with ambitious investment, and depended on their natural resources, especially crude oil.

Third, all of them are holders of foreign debt in high ranking worldwide.

Fourth, all of them have experienced severe setback resulting from their reckless avidity. Indonesia is one of the failure cases proving that advantageous and favorable natural environment never guarantees prosperity without rational human efforts.

The Indonesian economy has maintained sustainable current account deficit of 2% of GDP until 1994. The current account deficit rose to a dangerous level of 3.7 percent in 1996. Generally speaking, if the current account deficit of a national economy surpasses 4%, the economy will be in danger. There were many factors, which caused the increase of the current account deficit.

First, the external competitiveness of Indonesian commodities was weakened rapidly as China devalued Yuan by 50% and Rupia was over valued due to the devaluation of Japanese Yen. The trade surplus decreased.

Second, the investment rate has always surpassed the high saving rate(about 30%) because the Indonesian government has pursued a high economic growth.

Third, the private sector borrowed foreign debt excessively after the liberalization of foreign capital inflow. The total amount of foreign debt was about two thirds of the GDP. The debt service ratio was about 34% in 1996. The use of foreign capital was not sound. To a considerable extent, the proceeds were used for infrastructure and other non-tradable industry including land-based industry like hotel, tourist resorts, real estates, shopping malls, and so on.

Fourth, the Indonesian government has played an important role in exacerbating foreign debt and current account deficit. The government attempted to decrease the burden of repayment of external debt with the proceeds by privatizing state-owned enterprises and with expenditure-reducing policy. The policies produced somewhat good results, such as, budget surplus and prepayment of expensive foreign debt. However, they permitted too many exceptions such as strategic industries, national car program and excessive infrastructure projects. The budget surplus that resulted from various efforts of the Indonesian government was not enough to counter the rapid expansion of the off-budget expenditure and government sponsored projects.

b. Banking Crisis

∓ Rapid Increase of Foreign Capital Inflow and Banking Credit

The core of the Indonesian financial crisis was the banking crisis and the core of the banking crisis was the loss of trust to repay debt to foreign creditors. The rapid increase of foreign capital caused a massive current account deficit, and therefore, the capability of Indonesian economy to repay debt was questioned. Furthermore a huge amount of Non-performing loans struck the banking sector's credit. Of course, a substantial increase of NPLs was brought about by rapid expansion of banking credit. The Indonesian monetary authorities have released many restriction (including interest rate, complicated lending ceiling with subsidized interest rate, entrance barrier, and so on) since 1983. These reforms have had a significant impact on the banking industry, and have especially promoted competition, as the reforms permitted the participation of new banks, foreign banks, NBFIs (Non-Bank Financial Institutes) in the banking sector. These reforms also lifted the restrictions on bank lending, asset activities, and [to lend in easier bankable sector as land-based industries. The excessive increase of bank credit caused a serious bubble in the Indonesian economy and produced disasters like NPLs for banks when the bubble burst. Also the excessive bank credit discouraged efficient investment of the Indonesian economy because the bank loan officer did not and could not evaluate the feasibility of the borrowers' projects.

The Indonesian financial authorities have been very generous to foreign exchange transaction relating to export and FDI (Foreign Direct Investment). The serial reforms since 1983 induced a huge amount of foreign capital inflow, which reached two thirds of GDP in 1997 as the foreign investors, believed that Indonesia was a very stable and promising emerging market. The foreign investors were interested in infrastructure project, working capital of Indonesian firms and banks, and capital market to acquire Indonesian companies equity and bonds. The unsustainable level of Indonesian foreign debt meant that the Indonesian authorities' autonomy of the monetary policy was almost lost and very fragile against external changes. Also the rapid and massive capital inflow contributed to an increase in the bank credit and to expand the bubble of Indonesian economy.

O Serious Mismatch of Maturity and Currency in Indonesian Banking Sector

As one of the distinctive characteristics of Indonesian banks, the Indonesian banks have a special asset structure that consists of short-term borrowing and long-term lending, and a considerable portion (18% in total debt in 1998) of the asset is denominated by foreign currency. The Indonesian bank's asset structure could be deadly poisonous for banks during the financial crisis.

The serial reforms permitted the Indonesian firms to open foreign currency accounts and to take loans denominated by foreign currency from banks. As a result, much of the private sector's debt was denominated by foreign currency and became a substantial danger. Because the Indonesian Rupia has historically shown a stable and predictable value, the danger was not explicit. The short-term borrowing and long-term lending provided banks with more profits during a peaceful time. The Indonesian banks tended to prefer the foreign currency denominated loan when the domestic interest rate was high due to funding cost.

The banks' asset combination of short-term borrowing, long-term lending and high portion of foreign currency denominated asset can be explained as undeveloped financial system without sound and capable supervisory institutes. The exchange rate of Rupia increased very rapidly from 1997 to 1998. The severe devaluation of Rupia inflicted Indonesian banks with serious disasters. The value of banks' asset decreased rapidly by the devaluation of Rupia because of their over valued foreign currency denominated debt. Most of them did not hedge their foreign currency liabilities. The Indonesian banks had to pay high cost to revolve their short-term liabilities during the financial crisis.

The unsound Indonesian banks' asset structure caused serious liquidity problem after the rapid devaluation of Rupia. Especially the unlisted banks that were incapable of raising long-term stable source of funding in the capital market had to undergo harsh difficulties. The high portion of foreign currency denominated lending also increased the burden of repayment burden, especially for their customers, which soon connected with increased NPLs. The Indonesian banks were critically hit by the collapse of customers and increased NPLs. Their situation and the path to failure were similar to the case of Korea.

O Weak Financial Position and NPLs of Banks

Liberalization of the banking sector lowered the capital requirement to enter the industry and reserve requirement. The 22banks (out of 240 banks in total in 1995) could not meet 8% of the capital adequacy ratio. The tendency of under-capitalization was conspicuous in state-owned banks. The weak capitalization of banks has strong correlation with NPLs. This phenomenon is that of vicious circulation.

Generally, undercapitalized banks want high yield and therefore take high-risk asset due to their poor financial position. The risky loan assets are apt to go bankrupt easily during a period of economic depression. The asset became non-performing loan and the non-performing loan eroded bank’s capital base.

In the case of Indonesian banking system, there is an implicit guarantee that the government will solve the insolvency of state-owned banks through fiscal budget. The state-owned banks did not need enough capital base and did not have an incentive to liquidate the problem loans at an early stage. The loan officer was quite powerless because they had to just follow governmental instruction; therefore, it was very difficult for them to evaluate risks and feasibility of projects. As a result, the non-performing loans snowballed in a short time.

O Government Involvement

Government involvement in the financial sector, meaning the allocation of limited resources via economic policy, is not a peculiar phenomenon limited to Indonesia, but a widespread practice in underdeveloped countries. Many banks have been established since the reform in 1988. The 6 state-owned banks were legally transferred to private banks in 1992.

Despite the privatization of many banks, the government still retains a strong hold on the ownership of banks. The government has interfered with all of the bank affairs (including personnel, technical affairs). Of course, the government was deeply involved in the loan decision making. Most of the beneficiaries had political connections and were the conglomerates that dominate the Indonesian economy.

The financial activities of current decades are quite different from those of previous times. The government officials are not financial experts; therefore can not be involved and must not be involved in banking industries. Furthermore, generally, their involvement is closely related to black transaction, such as bribe. The unnecessary interference of the government distorted and spoiled the financial sector. It was one of important factors which triggered the collapse of the Indonesian economy.

The Indonesian financial authorities adopted the CAMEL(Capital adequacy, Asset quality, Management, Earning, and Liquidity) system to regulate and to supervise bank more prudently in 1991 after the substantial liberalization of the banking sector. However, the restrictive system was not rigorously implemented. The necessary requirements, prudential supervision for the advancement of financial system liberalization are not problems of formal regulation but the will of regulators for rigorous implementation.

O The Central Bank: Bank Indonesia

The primary role of the central bank generally consists of three categories, which are: issuing and management of domestic currency, supervision for financial sector, and lastly, acting as lender of last resort.

Though the Bank Indonesia adopted the CAMEL system in 1991, the Indonesian financial system lacked a sound market infrastructure. Some banks relating to big conglomerates often-violated limit regulation which restricted lending to special related parties like sister companies or owner of banks. In this case, the banks are unable to fairly evaluate their sister companies and their projects; therefore, much of the loans for sister companies can be non-performing loan. The loan assets mainly came from the deposits owned by the public but there was no deposit insurance. There was always the danger of bank run against extremely unfavorable shocks.

Bank Indonesia played an important role as the lender of last resort during the financial crisis. The Bank Indonesia provided distressed banks with equity capital injections, liquidity credit, financial supports, and acquired shares of problem banks. The function of the central bank as the lender of last resort is to prevent distressed banks from bank run at a crisis. Many banks depended exclusively for their survival on the financial injection from the Bank Indonesia. In reality, it is argued that Bank Indonesia is only acting as the lender of last resort for state-owned banks and for politically well connected financial institutes.

3. Consequences of the Indonesian Financial Crisis

The Asian financial crisis was triggered by several attacks of international speculators. The Indonesian government asked for the IMF rescue package, and the total amount of US$ 40billion IMF rescue package program was signed in November 1997.

The Bank Indonesia abandoned the exchange rate intervention band and moved to the floating exchange rate system to preserve its external reserve position. The external value of the Rupia was depreciated seriously, and the Rupia was recorded at 17,000 to a dollar on January 22, 1998. The composite stock price index at the Jakarta Stock Exchange plunged by more than 50 percent from July 1997 to August 1997. At the same time, bank deposit and loan interest rate rose to over 50 percent per annum. Especially the closures of 16 financially distressed private banks in November 1997 ignited bank run, panic buying and capital flight. Because of losing confidence from the international financial market, the Indonesian banks could not rollover their short-term foreign debt. The Letter of Credit issued by the Indonesian banks was also rejected. The Indonesian people experienced harsh distress. President Suharto resigned in May 1998.

a. Fiscal Stabilization Programs

With the collapse of Indonesian economy in 1997, the Indonesian government was forced to implement stabilization policy to decrease budget deficit. The Indonesian government has maintained a balanced budget. If the budget deficit was inevitable, the budget deficit was offset by ODA(Official Development Aid) and privatization proceeds. But everything has changed since 1997, and thus, the Indonesian government had to solve the problem of budget deficit which imposed heavy pressure directly on aggregate currency and inflation rate. The government had to increase revenue from tax and profits of public enterprises. It was very difficult for the government to raise revenue from the private sector due to economic recession, rising unemployment rate and high inflation rate.

However there was a huge demand for the government expenditure to pay for public external debt, to stabilize consumer price, to lower unemployment and to restructure banking sector.

There was the only way to decrease the budget deficit. The government has borrowed a huge amount of money from the central bank to appropriate proceed for banking restructuring of IBRA(Indonesia Banking Restructuring Agency). The government borrowing from central bank means printing money, which is the most soft solution to raise public tax without tax resistance, but which can incur many difficult side-effects.

b. Bank Restructuring

O IMF Recommendations

First, the IMF recommended the Indonesian authorities to merge the weak banks to strengthen the banking system.

[The authorities announced, December 31, 1997, the plan to merge four state-owned banks(Bapindo, Bank Dagang Negara, Bank Bumi Daya and Bank Exim) into one entity. This was followed by the announcement of several banks, in January 1998. Bank International Indonesia(BII), Bank Dagang Nasional Indonesia(BDNI), two of Indonesian largest private banks, have agreed to merge with three other smaller banks(The Meltdown of the Indonesian Economy in 1997-1998, causes and response, Anwar Nasution)]

Second, the IMF recommended the authorities to expand new injection of capital including foreigner for bad banks.

Third, the Indonesian government established IBRA(Indonesian Bank Restructuring Agency), an independent agency under the Ministry of Finance, to implement overall banks restructuring according to IMF recommendation . The IBRA replaced Bank Indonesia's position as the lender of last resort to itself. The central bank was in danger because it spent excessively for the expense of budget deficit.

Fourth, the IMF recommended the Indonesian government to operate state-owned enterprises, including state-owned banks, more accountably and transparently. The evaluation of bank managers should be measured by performance contract to evade interference. The IBRA is mainly engaged in supervising distressed banks that need restructuring and managing restructuring process. Another important role of IBRA is to manage the assets required for banks restructuring process. The IBRA announced that it suspended 7 banks business operation, took 7 banks management and took control of 40banks(including 3 state-owned banks, 11 regional development banks, 26 private commercial banks) under IBRA's supervision. The 3 state-owned banks were Bank Bumi Daya, Bank Pembanguan Daerah and Bank Dagang Negara. The IBRA depended on central bank for raising fund to implement banks restructuring process.

Fifth, the IMF recommended that Bank Indonesia, the central bank, have full autonomy in formulating and implementing monetary policy.

Sixth, the IMF required the Indonesian government to be equipped with a more practicable infrastructure, prudential rules and regulation, regarding the financial system. Its purpose is to strengthen the capability of Bank Indonesia to supervise banking industry and to enforce the prudential regulations.

Seventh, the IMF recommended that the authorities explicitly provide full guarantee on deposits of all banks in Indonesia to restore confidence of domestic and international community on domestic banks. The policy was expected to help foreign banks in accepting the Indonesian bank's Letter of Credit and to prevent bank run.

O Bank Indonesian Bank-Restructuring Plans in August 1998
(EIU Country Report 4th quarter 1998)

Recapitalization

Bank Indonesia will decide which bank may gain capital from the government by a financial review of all banks and business plan of selected banks. The selected banks will receive new capital from the owner or other investors including the government. Government participation is temporary and its title of ownership is represented by IBRA. All bank obligations obtained from Bank Indonesia liquidity support will be transferred to IBRA, which then converts them into equity or subordinated loans.

* Improvement of rules and regulation

These are amendments to the Banking Act of 1992, submitted to the parliament on August 4, 1998. Bank licensing, previously authorization with the Ministry of Finance, will be transferred to Bank Indonesia. Foreign investors may take bank's share more easily. The IBRA will be operated at given legal basis.

* Improvement of prudential regulation

Banks are required to meet the capital adequacy ratio of 4% by the end of 1998, 8% by the end of 1999 and 10% by the end of 2000. Stricter actions will be taken against owners and manager who violate regulations.

* State-owned banks

Bank Exim, Bapindo, Bank Bumi Daya, Bank Dagang Negara and the corporate business of Bank Rakyat Indonesia are to be merged into one bank. Bank Rakyat Indonesia(BRI) will concentrate on small credit and retail banking to support small-scale enterprise and cooperatives. The non-performing loans of the BRI will be transferred to the Asset Management Unit(AMU) of IBRA.

* Suspended banks

The assets of the seven banks suspended on April 4, 198 will be transferred to the AMU.

* Taken-over banks

Of the seven banks, Bank Danamon, Bank Modern, Bank Umum Nasional, Bank BDNI, Bank PDFCI, Bank Tiara and Bank BCA, the operations of three(BDNI, Bank Umum Nasional and Bank Modern) will be suspended, while the other four will be retained by the government in order to restructure their capital. The owners of Bank BCA, Bank Danamon, Bank BDNI and Bank Umum Nasional wanted to provide fund and assets. The government set a condition that the funds and assets provided by the owners-founders must cover all credits to their groups and affiliates as well as BI liquidity support.

c. The External Debt of the Private Sector

Most of Latin-American countries announced moratorium for repayment of foreign debt in the early 1980's. As a result, those countries could not have access to international financial market through 1980's as a punishment from the international community. The repayment of foreign debt is very important because the international capital market remembers the borrower's behavior for a long time.

The total foreign debt was US$ 133.69billion in 1997, of which US$ 67.67billion was private sector's foreign debt and much of them was short-term debt. The Indonesian government proposed to temporally freeze the paying private sector's external debt.

The basic principle of the government policy was not to interfere and to support repayment of private sector debt. The agreement among the representatives of government and private sector of Indonesia and the steering committee of foreign lenders was reached in June 1998.

[The private sector's external debt problem is to be solved based on a combination of Mexico's Ficorca program and the Korean scheme. The Korean plan takes the short-term, non-trade debts of Indonesian banks(US$ 8.9billion) and restructures them into loans with one to four years maturity. The non-bank corporate external debt(US$58.79billion) will be rescheduled and restructured along the lines of the Mexican programs. A trust institution, called INDRA, is to be established by the government of Indonesia and administered by Bank Indonesia(The Meltdown of Indonesian Economy in 1997-1998: Causes and Responses, Anwar Nasution)]

The INDRA(Indonesian Debt Restructuring Agency) announced its 8 principles for solution of corporate debt.

INDRA is an intermediary institution.

Both the debtor & creditor must agree to its participation in INDRA.

The government shall not assume the responsibility of commercial risk.

The government does not take over and bail out the private sector debt.

INDRA has to be self-financing, to avoid automatic granting of subsidies.

The whole or part of the private debt is eligible for INDRA scheme.

The objective of INDRA is to reduce the burden of short-term external debt repayment, which will support the balance of payments condition.

INDRA scheme is designed to ease the short-term liquidity problem faced by the Indonesian firms. If any government assumes the private sector's debt in place of the collapsed corporate, both the creditors and corporate will never learn lesson from their mistakes. It is understood that the principle of the Indonesian government is not to repay the private sectors' foreign debt as a reasonable way. However its policies can be the most regretful thing in the near future because the strong countries to which the creditors belong decide the order of the international financial market.

d. Reform of Bankruptcy Law

One of the most notorious things for foreign creditors was the Indonesian bankruptcy legal system. The bankruptcy law focused on the protection of creditor's right. In reality, the law lacked detailed enforcement measures and was doubtful of its practicability.

[Though 90% of Indonesian listed corporates are in default, none of them went bankrupt. For example, the Peregrine securities in Hong Kong is in a liquidation process because Steady Safe, the Indonesian transportation company, announced default for US$ 350million debt from the Peregrine securities. But Steady Safe is engaging in its business as usual(The Economist, The living dead, on January 24, 1998)]

These kinds of practice cause moral hazard of the borrower and bankruptcy of creditors, especially financial institutes. This issue is one of the main causes of the Indonesian financial crisis.

Of course, the foreign creditors made a strong request to the Indonesian authorities for the reform of the bankruptcy law. The new bankruptcy law began to be effective after August 20, 1998. A fair treatment of creditors, whether domestic or foreign, is the leading principle of the new laws. No debtor can receive a discharge as a result of either suspension of the payment offer of a settlement or reorganization plan to his creditors unless he pays the amount of his debts in full or qualified majority must accept the plan.

O Bankruptcy

In the case of bankruptcy proceedings, the debtor’s assets are liquidated to pay the creditors claims according to the ranking of such claims. The court can declare a debtor bankruptcy on a summary finding that the debtor has at least two creditors and that at least one of the two debts is currently due and payable. The creditor should provide evidence that the debtor has caused to pay his debts. There is not any time limit for all debts to be the evidence of the bankruptcy.

Unsecured creditors have no priority and will be paid, if any proceeds of the assets remain after all other creditors have received payment. They are required to present their claims to the court receiver.

Secured creditors have the right to separate the collateral from the debtors asset and to enforce against the collateral. The secured creditors will only become involved in the bankruptcy proceedings if the value of the security is not enough to cover their claims.

- Suspension of Payment

This process offers the debtor temporary relief against the pressing creditors in order to reorganize and continue his business, and ultimately to satisfy the creditors claims. Suspension of payment can easily be converted into bankruptcy when it is clear the reorganization of the business will not be successful. On the other hand, the bankruptcy can not be converted into a suspension of payments.

Chapter IV. Conclusion

a. Summary of Key Findings

This thesis examined the Indonesian financial system in the context of the financial crisis.

The Indonesian financial system has been liberalized broadly and has expanded rapidly without an adequate control system. The liberalization attracted external debt and substantially expanded bank credit. Excessive external debt, especially short-term debt impeded autonomy of the monetary policy. Extraordinary credit expansion resulted in a huge amount of NPLs. The Indonesian economy finally collapsed because of the crashed financial system, irrational exchange rate system, weakened export competitiveness, etc. The main problems of the financial system were under-capitalization of banks, excessive currency and maturity mismatch of assets, government involvement, heavy burden of NPLs, bankruptcy legal system, non existence of prudential regulation and supervision, and etc. However, the most fundamental reason was the moral hazard of the government and the financial system.

b. Suggestions for Improving the Banking System in Indonesia and Korea

There are many commonalties between Indonesia and Korea regarding the financial crises. The most salient factor is the deleterious-both external and internal- environment of the banking system in the respective countries, which has played a very important role in triggering the financial crises. Above all, these factors must be improved for the banking system to contribute to the national economy.

O Internal Reforms

Many people point out the politicians' and government officials' deep involvement in the deteriorated banking system. This is true. But the real responsibility belongs to the bank personnel. Traditionally, the government made decisions on lending related to big projects and became involved in all bank affairs, especially personnel affairs. Therefore, the bank officers had no incentive to carefully evaluate a project and to review customers credit because they often do not have the authorization to reject loan application in those cases. If a bank loan officer wanted promotion, he had to please senior officers and government officials. This is the origin of corruption and distortion of the financial system. Here, I would like to suggest two solutions to improve the distorted banking system.

First, the evaluation of the bank loan officer should be measured by his performance.

Second, the banking system should be transformed from a highly hierarchical generalist organization to a flat expert organization. If a bank officer is an expert in a specific field and is evaluated by his performance, he does not need to have to worry about his senior's face and government official's interference. The expert should be equipped with the necessary expert knowledge so that his expertise can overcome whatever interference. The pre-condition of flat expert organization is satisfactory economic compensation for the expert instead of promotion. If people do not care about promotion by getting enough compensation according to their performance, the external interference can be meaningless. This is the first step to disentangle the distorted banking system.

b. External Reform

The worst thing in financial transaction is default. If a borrower does not repay his debt, he should be punished. All of his wealth should be confiscated and repaid to the creditor. The borrower should be left to be a beggar without a penny after default. It is the justice of capitalism. In reality, sometimes the borrower in default is financially well off, though he fails to repay his debt. This circumstance may cause a moral hazard because the borrower does not need to care about his liability. These kinds of moral hazard are pervasive in Indonesia. It is an outright refusal of the principle of capitalism. Who dares to do business in that circumstance? Similar nonsense also occurs in Korea very frequently. Establishing a systematic apparatus is indispensable as it discourages people from the moral hazard due to severe punishment.

O Indonesia

There are many reasons why the Indonesian economy and the banking system collapsed. But the problem seems to be the moral hazard. If a person does not have to worry about the loss of his all-economic belongings when he defaulted on his debt, a rational economic system and a reasonable financial system may never be achieved in spite of any official legal system. I examined the Indonesian new bankruptcy system in the preceding section. The new bankruptcy law has many implications, which can be the perfect solution to restore confidence of the Indonesian financial system and economic justice under capitalism. I do not believe the important thing is formal institutions, but rather, the will of the people.

O Korea

The economic environment relating to moral hazard in Korea is not better than that of Indonesia. The GDP per capita level of Korea was more than 10 times higher than that of Indonesia before the financial crisis. Even though the size of Indonesia is more than 20 times larger than that of South Korea, the total amount of export in Korea is over 2.5 times larger than that of Indonesia. But I have difficulty in judging who is better off in terms of financial system or moral hazard.

Korean or Indonesian distressed loan assets can not attract international investors at present day. On the other hand, Thai assets are more popular than those of Korean or Indonesian, and Hong Kong companies' assets are most popular in South-Asia. Some investors indicated that they could forecast the future liquidation process reasonably under the Hong Kong legal system. This means the predictability and stability of the legal system are necessary conditions to attract international investors.

Most Korean banks accept mortgages for real estate as collateral. There is a certain ranking among collateral, where the ranking is registered in court. The mortgage principle, to which advanced creditor has priority over appropriating debtor's asset for his credit. The principle is very important for the financial institutions as it decides their portion when the debtor collapses.
However, the principle is ignored very often, which means that the ranking of mortgage is meaningless. If any big corporation is in default, it will mostly go to composition or court receivership instead of the liquidation process. This means that a creditor can not take his credit according to the mortgage ranking and the debtor can maintain his business and assets. I think that the Korean court abuses composition and court receivership, and its decision spoils the economic justice. The abuse of composition or court receivership caused serious moral hazard of corporate and financial institutes.

First, the corporation do not fear forceful deposition of his assets by bankruptcy.

The government always protects their business and assets, and bails out their debt. Korea is a heaven for an immoral corporate owner.

Second, financial institutions should always look over their mortgage ranking carefully. If they are subordinated rankers in mortgage, they have to check carefully the debtor's credit and the feasibility of projects. But the principle is a ridiculous one because mortgage ranking is generally meaningless when big corporation go bankrupt. The Korean financial institutions do not have the incentive to evaluate debtor's credit and project because there is no difference between the senior ranker and subordinated ranker.

To develop a sound financial system, all of the above should be fundamentally improved.

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