GLOBALIZATION:
THE ROLE OF INSTITUTION BUILDING IN THE FINANCIAL SECTOR
THE CASE OF INDONESIA

I. INTRODUCTION

Globalization has become a common theme around the world since the early 1980s. It is a process characterized by the increasing integration of goods, labor and financial markets, without regard for international boundaries with the ultimate of goal of pursuing a single global market[1]. This process of global economic integration has been accelerated by rapid advances in information, communication, computing, as well as transportation technologies, which have made it easier and quicker to complete international transactions for both trade and financial flows.

It is interesting to note that a main impetus for this globalization process has been the increased integration and globalization of the financial markets, which in turn have been supported by the abolition of capital controls and by a drastic decrease in transaction costs brought about by new communication and information technologies as well. Financial globalization, in combination with good macroeconomic policies and good domestic governance, appears to be conducive for economic growth.

Nevertheless, though globalization has brought broader opportunities for rapid economic growth, it should also be noted that the distribution of benefits across countries is still an open issue. Recent financial crises have shown that globalization, especially when it relates to the integration of domestic financial markets into a global market, provides not only opportunities but also challenges as capital flows can magnify economic booms as well as deepen economic crises with destabilizing effects on an emerging economy.

The contributing factors to the emergence of the recent financial crisis seemed to be the result of home-grown vulnerabilities related to financial sector weaknesses, overvalued exchange rates, and unsustainable fiscal positions, often accompanied by volatile market sentiment and contagion effects from other countries. Despite the above-mentioned reasons, weak institutional and regulatory infrastructures were the principal contributing factors to the emergence of the Asian financial crisis, particularly in the case of Indonesia. To this end, strong institutions and viable regulatory frameworks are necessary for countries to reap the benefits of globalization. To realize the great potential that may arise from globalization, countries need complementary institutions and sound economic policies.

[1] IMF, Globalization: Threat or Opportunity?, April 2002

Considering the importance that financial institutional building plays in dealing with the opportunities and challenges posed by globalization, this paper will focus on the role that Bank Indonesia and the Ministry of Finance, as government institutions, have played in helping build and prepare the financial sector to deal with globalization forces. Section II will outline bank and non-bank financial institution reform in Indonesia; Section III will outline the role of institution building in the financial sector in Indonesia and how it relates to globalization; Section IV will discuss the need for further institutional changes in the country to prepare for the future; Section V will discuss lessons to be learned; and Section VI will conclude the discussion.

II. THE POLICY APPROACH TO GLOBALIZATION IN INDONESIA

Bearing in mind the beneficial aspects of globalization, the Government of Indonesia is of the view that the country cannot isolate itself from the global trend towards market integration. Thus, since the early 1980's, the Government has launched a series of policies and deregulation measures designed to increase non-oil exports, simplify the tax system, reduce subsidies, and enhance expenditure efficiencies, among others, in order to sustain a dynamic but balanced budget, attract more foreign investment, strengthen the financial sector, and improve the effectiveness and efficiency of various government institutions.

The following sections explain the types of financial sector reforms that have been undertaken for both banks and non-bank financial institutions (NBFIs), as well as the appropriate policy approaches.

a. Banking reform in Indonesia

Banking sector reform in Indonesia can be divided into two phases. In the *first phase* (pre-1997 crisis), reform in the banking sector was driven by domestic needs; while in the *second phase* (post-1997 crisis), reform mainly stemmed from the need for adjustment to pursue globalization.

Furthermore, banking sector reform in Indonesia itself can be divided into five distinct periods: (i) the high inflation period (1966-1973); (ii) the interest rate ceiling period (1974-1983); (iii) the banking reform period (1983-1988); (iv) the banking policies adjustments period (1988-mid 1997), and (v) the bank closure and consolidation period (1997-to present).

1966-1973 (the high inflation period)

Prior to 1966, banking in Indonesia was in its early development stages, emerging from an environment still dominated by the banking regime established during Dutch colonial rule. It was also the beginning of the national banking era during which time the emergence of state and private national banks first occurred. The degree of monetization in this period was fairly low, reflecting the situation of an underdeveloped economy.

Under the Old Order Administration era (1945-1966), the government experienced political instability, along with a lack of coherent economic policy and falling exports. An increasing government deficit stemmed from over-spending in inefficient government projects, which forced the Old Order Administration to print moneyat a very fast rate. This lack of financial discipline was the major cause of severe inflation during the years that followed, with the inflation rate surpassing 600 percent.

To address the situation, Bank Indonesia decided to establish a reserve requirement as an instrument of monetary policy, i.e. the requirement of commercial banks to maintain a liquidity position with the central bank on the basis of their deposits. In addition, to simplifying daily financial transactions and further coping with the high inflation rate prevailing at that time, the government decided to change the nominal value of rupiah by moving the decimal by three places, with effect that Rp.1,000.-become Rp.1.

Soon after, in 1966, the New Order Administration launched an economic stabilization and rehabilitation program aimed at reducing inflation and ensuring a sufficient supply of basic necessities. At the same time, the administration worked to reconstruct domestic infrastructure and carried out various efforts to create export capacity. To achieve these objectives, the government adopted a budget policy, which limited expenditures up to the level of domestic revenues and counterpart funds generated from foreign aid. In addition, foreign exchange controls were removed, and for the enhancement of investment activities, new laws regarding domestic and foreign capital investment were enacted.

In addition, the government began to implement monetary policy primarily through the regulation of credit and interest rates, as follows:

i. Establishing and requiring the application of tight credit policies and directly controlling state bank lending rates for different categories of credits.

ii. Setting lending rates within a range of 6 to 9 percent per month, and then gradually reducing these starting from April 1967.

iii. Urging banks to provide credits for important economic sectors, with the objective of eliminating different treatment between state enterprises and private corporations, and to improve the credit procedures.

iv. Introducing saving drives intended to create incentives for savers by means of offering higher interest rates on deposits, up to 60 percent per month for one-year time deposits, in addition to providing repayment guarantees from Bank Indonesia, providing tax free facilities, no examination of the source of the deposited funds, and providing subsidies to state banks due to higher deposit rates than lending rates.

As a result of the policies described above, the growth of money supply was reduced from 123 percent; per annum in 1968 to 57 percent in 1969, to 38 percent in 1970, and to 28 percent in 1971. The inflation rate also declined from 650 percent in 1966 to only 2.5 percent in 1971.

1974-1983 (the interest rate ceiling period)

During 1972 and 1973, inflation once again rose sharply, reaching 26 percent in 1972 and 27 percent in 1973. This situation was mostly brought about by the expansion of bank credits as a result of increases in the mobilization of funds and Bank Indonesia's liquidity credit (KLBI) scheme. Furthermore, in 1973, the rapid increase in inflation also stemmed from the first oil shock, which spurred a sharp increase in the value of exports, gross domestic product, budgetary receipts, and consumption spending.

To restore economic stability and maintain the pace of economic development, the government introduced a new stabilization program, the so-called *April 1974 package,* which targeted stabilization in the financial and monetary sectors. With respect to monetary measures, Bank Indonesia began to pursue direct monetary control by applying a system of individual bank credit ceilings as a primary defense against excessive domestic money growth, and regulating deposit and lending rates. Bank Indonesia provided liquidity credit support to such an extent that banks were able to make large amounts of credit available with low lending rates. In addition, Bank Indonesia also allocated and extended credits directly to priority sectors of the economy in conjunction with government programs. The opportunity to provide large amounts of liquidity credit was made possible by the increase in oil export proceeds and foreign exchange reserves.

The aim of these measures was to ensure that banks in Indonesia were dedicated to their functions as agents of development. Banks relied on liquidity support from Bank Indonesia for their sources of funds. Financial positions showed that total deposits were below total credits for the period between 1979 and 1984. Under the liquidity support scheme, banks obtained a certain margin of interest for the amount of credit extended to borrowers. This incentive, however, was only made available to state and other selected private banks that satisfied certain minimum criteria related to their soundness rating. This incentive also had the intent of discouraging banks from finding other sources of funds, particularly from the public, since deposit interest rates were less competitive compared to interest rates for the liquidity support scheme.

1983-1988 (the banking reform period)

The extension of liquidity credits financed by the oil boom in the 1970s had important affects on the behavior of fund mobilization by the banking sector. Deposit growth in state banks, where rates were fixed by the central bank, was lower than the growth of deposits in other banks, which were free to set their own deposit rates. However, the extension of liquidity credit from the central bank to state banks increased significantly, from 37 percent at the end of 1979 to 47 percent at the end of 1982, while for other banks, it rose only from 10 percent at the end of 1979 to 17 percent at the end of 1982.

The deterioration of foreign reserves in the beginning of 1980, due to the reduction of oil prices, forced the government to encourage banks to be self-reliant in carrying out their intermediary role. To this end, the government adopted a broad range of actions including policies to deregulate the banking sectors. The aim of the banking reform effort that was started in 1983 was to reduce the government's involvement in stimulating economic growth and improve the capability of commercial banks in mobilizing savings and deposits.

With the banking deregulation efforts adopted in June 1983 the government began to remove the remaining interest rate controls on state banks, and abandoning the system of controlling bank credits through administered ceilings in favor of a more market oriented approach relying on the development of indirect monetary instruments. Following these deregulation measures, Bank Indonesia adopted indirect monetary instruments, namely in the form of reserve requirements, discount facilities, and open market operations. The fundamental reforms in the banking sector undertaken in June 1983, gave rise to satisfactory developments in the banking sector for both the mobilization of funds as well as the extension of credits.

1988 – mid 1997 (the banking policies adjustment period)

Although the fundamental reforms in the monetary and banking fields adopted in June 1983 had led to satisfactory developments, these developments only provided the banks with the freedom to set their lending and deposit rates directly. They also allowed the central bank to implement monetary policy through the use of indirect monetary tools rather than through the use of direct monetary instruments. The reform measures did not include institutional as well as market environment changes. The expansion of bank networks was needed not only for the increase in the monetization of all economic activities across the country and the enhancement of public funds mobilization, but also for the expansion of banking services, including the promotion of non-oil exports. An environment that enables banks to create new products was also needed for the further enhancement of public fund mobilization, and the stimulation of sound competition, important ingredients for an increase in efficiency.

Against this background, Bank Indonesia undertook a series of policy measures in the financial, monetary and banking fields on October 27, 1988. The purpose of these additional deregulation measures, which served as an integral part of the government's efforts to further deregulate and debureaucrateize these sectors, was to promote the further mobilization of funds, the development of non-oil exports, enhance the efficiency of banks and other financial institutions, as well as improve the effectiveness monetary policy implementation, and the climate for the development of the domestic capital markets.

Policies on funds mobilization included: (i) providing facilities for the opening of new branch offices of banks and NBFIs, the establishment of new private banks, and the establishment of rural credit banks, (ii) providing the freedom for banks to further develop savings schemes, and (iii) giving opportunities to mobilize funds by issuing certificate of deposits. These measures were expected to encourage banks to introduce new products to mobilize and invest funds in the form of many types of credits, as well as to provide professional banking services. The opportunities for opening bank branches and establishing new banks were also expected to widen the banking network and, therefore, stimulate savings habits and expand banking services throughout the country, including in rural areas.

The promotion of non-oil exports required expansion and improvement of banking services. For this purpose, the deregulation measures involved: (i) opening opportunities for the expansion of foreign exchange banks, (ii) establishing joint venture banks, and opening sub-branch offices of foreign banks; (iii) establishing money changing establishments to promote tourism, (iv) improving the mechanism of foreign exchange swaps; (v) abolishing foreign borrowing ceilings for banks and NBIF's, and introducing foreign exchange net open positions; (vi) continuing the extension of export credits with interest rates adjusted to the market, and (vii) requiring joint venture banks and foreign banks to provide 50 percent of total credits for export purposes..

In order to increase the efficiency of banks and NBFIs, a climate to induce sound competition also needed to be created. Toward this end, the expansion of banks and bank offices, and the freedom to create new products for funds mobilization and extension of credits were important aspects of the measures. Other deregulation measures for this end also included provisions that permitted both state owned and regional government owned enterprises to deposit up to 50 percent of their funds at private banks, as well as allowing bank mergers to go ahead.

Satisfactory results with respect to funds mobilization, improvement in efficiency and services to the public, competitive interest rates as well as improvement in the inflation rate and the foreign exchange rate movement of the rupiah against foreign currencies were indications of a new business environment that enabled banks to grow efficiently and was more supportive of economic development efforts. Nonetheless, while endeavors to reduce the amount of liquidity credits provided by Bank Indonesia had been made, the fact was that these continued to rise. This was considered an unfavourable phenomenon for the development of the financial sector. Therefore, to limit further liquidity support growth, Bank Indonesia changed its policy objectives to reduce gradually the role of the Bank in the extension of bank credits to various programs and activities, and in the provision of funds and extension of credits for those objectives by:

i. a limited amount of liquidity credits was provided only to support the continuous efforts for food self-sufficiency, the development of cooperatives and the enhancement of investments. Credit programs for small farmers and credits for cooperatives were further continued and improved.

ii. other types of liquidity credits were no longer provided. Instead, liquidity credits were shifted to ordinary credits to be extended to banks and other financial institutions based on their deposit base.

iii. efforts to reduce interest rates to reasonable levels through prudential control of inflation and rupiah exchange rates were pursued. For this purpose, in line with the spirit of the deregulation objectives, monetary policy continued to be implemented through the use of indirect policy instruments.

iv. a program for the safe availability of funds for small scale industry and productive activities of cooperatives was supported through credit allocations of each bank amounting to 20 percent of its total credits.

The financial reforms that Indonesia undertook since 1983 indeed boosted the intermediary functions of the banking industry. In fact, the banking sector succeeded in supporting strong economic growth for more than a decade before the crisis struck the country. This was particularly reflected by a rise in the number of banks and bank offices, the amount of funds mobilized from depositors, and the reach of credits extended to the business sectors. The number of banks almost doubled from 124 to 240 from October 1988 to July 1997, while the amount of deposits and credits increased from Rp.37.4 trillion and Rp.50.4 trillion to Rp.316.0 trillion and Rp.340.0 trillion, respectively, over the same period.

BANKING INDICATORS: October 1988 - July 1997

	Oct 1988	Jul 1997
Number of banks		
Commercial banks		
Banks	124	240
Offices	1941	6344
Rural banks	8041	9218
Deposits (trillion rupiah)	**37.4**	**316**
State banks	22.5	97.9
Private banks	11.1	187.5
Regional banks	1.3	8.6
Foreign/Joint-venture banks	2.5	22
Credits (trillion rupiah)	**50.4**	**340**
State banks	36	120
Private banks	11.3	179.8
Regional banks	1.2	8.2
Foreign/Joint-venture banks	1.9	32.1

1997 - to the present (the bank closure and consolidation period)

Despite the tremendous growth in the sector prior to 1997, policies failed to address other weaknesses that had arisen in the banking industry. The extent of delinquent loans in the state-owned banks illustrate the degree to which bank loans had been used as vehicles for directed lending to non-commercial ventures prior to the 1997 financial crisis. Similarly, the high level of lending to subsidiaries and other connected entities in many of the private banks indicate the use of banks as vehicles for channeling deposits to owners and for expanding business conglomerates. Banking supervision was largely ineffective, both because of the lack of qualified bank supervisors, and because supervisors were constrained from doing their jobs. While the doors were opened for entry of new banks into the industry, no proper exit mechanism was set up for banks that failed to operate profitably. Furthermore, the absence of some form of deposit insurance scheme, coupled with the moral hazard created by bank owners and their conglomerates as well as by their close connections to the government decision makers, constrained the ability of supervisors to execute their duties properly and close problem banks. These problems remained largely hidden, disguised by the economy’s fast growth rate, but once growth subsided, the true state of the banking sector quickly became visible. These weaknesses were subsequently unveiled after the currency crisis , which unfortunately also made these problems complex and difficult to resolve.

At the onset of the crisis, following the floating of the Thai bath on July 2, 1997, the rupiah came under severe speculative attack. The authorities defended the exchange rate by widening the managed floating band coupled with heavy intervention in the foreign exchange market. But by August 14, 1997, the attacks became to expensive to defend, forcing the authorities to abandon the band. The rupiah was thus allowed to float freely against foreign currencies. Nevertheless, the attacks continued, leading to panic buying and herd behaviour, which led to further depreciation of the rupiah. By October 1997, the currency had depreciated by close to 40 percent against the US dollar, the largest depreciation experienced among the Asian crisis countries. As a result, the currency crisis in 1997 led to the worst performance of Indonesian banking industry in the history of the country. Return on assets among bank dropped sharply from 1.22 percent at the end of 1997 to (–18.76 percent) by the end of 1998. Against this background, the Indonesian Government finally requested the IMF's assistance in early October 1997.

As part of the measures included in the banking resolution package formulated under the IMF program, the Indonesia authorities closed 16 insolvent banks and provided limited deposit insurance for bank depositors through the extension of liquidity support from the central bank. The authorities protected depositors for up to Rp10 million (around U$3,000 at the then prevailing exchange rate), which covered some 90 percent of the country's depositors, but a far smaller share (under 25 percent) of total outstanding deposit amounts. However, together with the growing political unrest, the wider impact of such bank closures were not largely anticipated. While these measures were aimed at restoring confidence in the banking system, they in fact had the reverse effect. In the absence of clear guidelines on depositor protection, and comprehensive bank liquidation policies, the decision prompted market panic and bank runs. Depositors withdrew huge amounts of funds, which were then invested in risk-free assets or sent abroad ('flight to quality' or 'flight abroad'). Consequently, a number of banks ran into liquidity problems. This situation and the risk of a complete collapse of the banking system forced Bank Indonesia to provide liquidity support to those banks affected.

The unexpected situation was due to the fact that the bank closures, as recommended by the IMF, were not complemented by other policies to prevent the possibility of large drains from the banking system in the absent of a comprehensive deposit protection scheme. Furthermore, political interest and connections also interfered with the policies established for closing these problem banks. The domestic economic environment deteriorated rapidly, with a further sharp depreciation of the rupiah, which also led to rising interest rates, while political instability increased as rumors about the President's ailing health spread. Moreover, given these developments and the deteriorating outlook for the country and the banking sector, foreign banks decided to cut their credit lines to Indonesian domestic banks in response to losses that were exacerbated by off-balance sheet transactions undertake with the closed banks. These developments rapidly eroded bank profitability and public confidence to the banking sector. By early December 1997, bank runs escalated and in January 1998 the situation in the currency market, the corporate sector, the banking system, as well as in the social and political spheres, was nearly chaos.

In the face of an expanding financial, political and social crisis, the government, including Bank Indonesia, under the renewed IMF program signed in January 1998, undertook strategic and comprehensive policies aimed at strengthening banking system. Those policies include:

(i) the restoration of public confidence, both national and international, towards the Indonesian banking industry through the introduction of *Government Guarantee Scheme* and the establishment of *Indonesian Bank Restructuring Agency* (IBRA),

(ii) the implementation of a bank restructuring program through the *recapitalization* of banks and the *restructuring* of the real sector, and

(iii) the improvement of *banking infrastructure*, the promotion of *corporate governance* and the improvement of *banking supervision*.

In order to restore public confidence and to avoid bank runs, starting January 27, 1998, the government introduced a full blanket guarantee on banks' liabilities. The new blanket guarantee scheme replaced the existing limited deposit protection. Under the new scheme, all forms of liabilities of the banks - to all depositors and creditors, domestically and abroad, both on-balance sheet and off-balance sheet - are guaranteed by the government.

With regard to restructuring the surviving financial institutions, bank restructuring was integrated with corporate restructuring to ensure that recapitalized banks were free from making loans to distressed corporations. Three agencies, namely IBRA, Indonesian Debt Restructuring Agency (INDRA), and Jakarta Initiative Task Force (JITF) were created to conduct corporate restructuring. IBRA's main responsibilities were to execute the operations of government blanket guarantee, to take over and rehabilitate ailing banks, and to manage the non-performing assets of those banks. The recapitalization program was aimed at preserving the viability of banks having good prospect to exist and was implemented through ownership restructuring, which was to be temporary and not intended to nationalize the particular banks in the long term. In addition, Bank Indonesia also instituted a special Task Force dealing with Loan Restructuring and Optimization, functioning as facilitator between debtors and creditors. The facilitating activities involve providing debtor information, arranging meeting between creditors and debtors, acting as mediator and observer, and providing technical assistance.

Technically, the details of recapitalization program involved the following steps. Due diligence process were conducted by international auditors for larger banks and in-house authority supervisors for smaller banks. Based on the result of due diligence, banks were classified into 3 categories, namely A, B, and C. Category A consisted of banks having CAR of at least 4 percent. These banks were excluded from the recapitalization program, but were obliged to submit business plan. Category B encompassed banks whose CAR calculated as less than 4 percent down to (–25 percent) and were required to participate in the recapitalization program. In addition, the management and owners of the banks had to undergo fit and proper tests. Category C comprised banks whose CAR were less than (–25 percent).

In 1999, 147 out of total of 237 national commercial banks were restructured or closed. These 147 banks consisted of 128 private domestic banks, 7 state-owned banks, and 12 regional development banks. Due to the nature of the reform program, these 147 banks could be divided into 5 categories. *The first category*, 74 private domestic banks having CAR 4 percent or above were considered as a "solvent" bank (Category A) and they were deemed to be able to compete effectively on their own, without any public financial assistance. *The second category*, 9 banks having CAR below 4 percent and above (–25 percent) were treated as "insolvent" bank (Category B). These banks were determined to make the necessary effort to be eligible for recapitalization by the government and attain the minimum capital requirements. *The third category*, 7 banks belonging also to "Category B" had to be taken over by IBRA in order to minimize the disruption to the stability of banking and payments system due to their size and extensive branch networks. *The fourth category*, 38 banks, comprising 21 remaining banks under "Category B" and all the 17 banks listed under "Category C" did not qualify for participation in the recapitalization program, and were closed down. *The fifth category* encompassed 7 state-owned banks that were deemed as the most important part of the Indonesian bank restructuring, because the total assets and extended loans of those banks held a dominant portion of the national loan portfolio.

To finance the costs for bank recapitalization program, the government had to issue bonds. In implementing the recapitalization program, the government issued recapitalization bonds that banks then held in their investment, trade, and collateral portfolios. These bonds were comprised of variable and fixed rate bonds, as well as hedge bonds. At the end of December 2002, government recapitalization bonds stood at Rp429.4 trillion, Rp99.7 trillion (23,8 percent) was held in the trade portfolio and Rp319.6 trillion (76.2 percent) was held in the investment portfolio.

No.	Category	No. of Banks	Description
DOMESTIC PRIVATE BANKS			
1	A	74	Could operate without additional capital
2	B	9	Met the requirements for recapitalization program
3	B	7	Taken over by the government
4		38	Closed down
T O T A L		128	
STATE-OWNED BANKS			
1		4	Merged and recapitalized
2		3	Recapitalized
T O T A L		7	

In sum, the source of the crisis can be traced to the acceleration of the process of Indonesia's economic integration to the world economy which has not been supported by well developed institutions as a prerequisite for the operation of an efficient market economy.

b. Non-bank Financial Institution reform in Indonesia

In Indonesia the non-bank financial sector consists of securities, insurance, pension funds and finance companies[2]. The largest and most important of the Non-bank Financial Institutions (NBFI), at least in terms of the funds involved is the capital market although insurance, pension funds and finance companies are also important (Table One).

Table One
The Non Bank Financial Sector in Indonesia

	Year	Rupiah trillion	Dollar billion	Share/GDP
Banking Sector (m2)	Dec 2002	883.91	98.87	54.90
Capital Market				
Stocks	Dec 2002	241.31	26.99	14.99
Bonds	Dec 2002	21.42	2.40	1.33
Mutual Funds	Dec 2002	44.38	4.96	2.76
Insurance				
Life (total assets)	Dec 2001	22.55	2.52	1.40
Non Life (total assets)	Dec 2001	14.81	1.66	0.92
Pension Funds				
Social (Provident/Gov)	Dec 2000	22.09	2.47	1.37
Private	Dec 2001	34.91	3.90	2.17
Finance Companies	Sep 2002	39.37	4.40	2.45
Note:				
Nominal GDP	2002	1,610.01	180.09	
Exchange Rate	Dec 2002	8,940		
Sources:				
Bank Indonesia, Indonesian Ministry of Finance				

[2] Finance companies are not permitted to take deposits, but are permitted to undertake leasing, factoring, credit cards and consumer finance.

However, the situation is changing rapidly. Since the crisis both insurance and private pension funds have been growing rapidly, in excess of 20% a year in nominal Rupiah terms. The capital market, with the exception of 1999 has not performed as well. With continuing macroeconomic stability, the currency has stabilized and appreciated while interest rates have fallen rapidly. This has ignited activity in the capital, bond and multi-finance markets in 2003, with the stock market capitalization reaching 346 trillion rupiah or over 40 billion US dollar by July.

Nevertheless, non-bank financial institutions in Indonesia remain relatively undeveloped. For example in market capitalization and insurance penetration international comparisons show that Indonesia has the lowest share among a selected set of comparators in the Asian region (Table Two).

Table Two Selected Non-Bank Financial Sectors Relative Size				
	Stock Market Capitalization (2002)		Insurance Penetration (2001) 1/	
Country	In USD mil	Share GDP	in USD mil	Share GDP
Indonesia	27,484.7	20.75	1,641.0	1.13
Malaysia	121,133.6	178.30	4,718.0	5.18
Singapore	103,239.1	165.71	4,005.0	4.58
Thailand	45,738.3	44.56	3,366.0	2.94
Philippines	18,792.0	38.04	906.0	1.27
Japan	2,116,180.0	72.80	445,845.0	11.07
Taiwan	269,671.5	113.74	24,253.0	8.62
Hong Kong	490,541.3	361.03	10,392.0	6.34
Sources:				
Capital Market – Bapepam Annual Report 2002				
Insurance – Sigma World Insurance 2001, Swiss Re				
1/ The values for Indonesia vary from Table One due to source.				

Policy reform history

The securities market was reactivated in 1977 but significant reform and activity did not begin until the deregulation period in 1987-1989. This was done through a series of measures designed to reactivate capital markets. The 1987 Package simplified share and bond issuance, allowed foreign ownership of 49% of listed shares and introduced a parallel burse for small cap stocks. The 1988 banking package introduced withholding on interest income and new rules on legal lending limits making the capital market more attractive, and the stock exchange was allowed to go public. With these measures activity in the stock exchange took off. From 24 stock and 8 bond issuers in 1987 there were 67 and 22 in 1989.

Between 1989 and 1995 a stock exchange regulator was created (Bapepam), a credit rating agency developed and gradually technology was improved to facilitate trading and liquidity in the market. An improved legal basis was put in place with the passage of a Capital Market Law in 1995. With this law regulatory authority was strengthened including criminal investigation powers to fight capital market fraud. The stock exchange, clearing & guarantee corporations, and securities depository were legally defined as self-regulatory organizations. Open ended investment funds were introduced and penalties for market manipulation and insider trading were increased. The pace of change slowed during the crisis but began to pick up again in recent years. Since 2000 scriptless and remote trading have been introduced, clearing has moved from t+4 to t+3, reporting requirements have been tightened. Finally an Islamic index was created and more recently a Syariah bond was issued. Most recently, as part of the government effort to reduce money-laundering and the financing of terrorism, know your customer regulations have been developed and are being implemented.

The government is itself an increasingly important player in domestic capital markets as bonds issued to recapitalize the banking system come due. The amounts coming due beginning in 2004 were potentially unstablizing and one of the government's key recent accomplishments has been to address this issue. First, bonds due to the state banks had their maturities extended at a constant net present value. This reduced the magnitude of the problem in the next few years. In addition Parliament passed a sovereign debt law and auctions of new debt issues have begun. The establishment of this market, and especially its size will facilitate the development of other markets and provide market players with longer maturity options. With declining interest rates mutual funds have begun to take advantage of this new bond market and are growing rapidly.

Other NBFIs, namely insurance, pension funds and finance companies have all also been subject to increasing liberalization, regulatory policy change and reform. For example an insurance law and supporting regulations were put in place in 1992. These established the licensing, procedures, and business conduct rules for insurance and reinsurance companies. These rules allowed 80% foreign ownership and numerous international insurance companies were established in Indonesia. More recently there have been regulatory changes that have mandated changed solvency requirements. Post crisis domestic insurance partners have had difficulty raising capital and the government has relaxed rules on foreign ownership. Most recently the Insurance Regulator has put Risk Based Capital measures and know your customer regulations in place.

Employer sponsored and financial institution pension funds in Indonesia are designed to supplement basic pension benefits provided through a mandatory provident fund (for the private sector).[3] The development of the pension fund to supplement the mandated social security was promoted with the passage of a law regulating pensions in 1992. In 1993 the Social Security system was reformed with the implementation of the Employees Social Security Act (Jamsostek). Since then Ministerial decrees have mandated, actuarial, audit and reporting requirements, as well as regulations on investment, including limits on the share of investment with any one investment institution.

Recent development and problems

Capital market reforms in 1987/88 (and later reforms in insurance and pensions) were aimed at mobilizing additional capital to support increased investment and growth. However, they were also designed to reduce the dependency on bank and foreign borrowing as well as increase of the quality and quantity of service to consumers. In the 1990s we saw rapid capital inflows in response to these and other reforms, rapid world growth, increasing integration in capital markets and low returns in a number of developed countries. And this capital inflow supported high growth in the 1990s – pre-crisis economic growth averaged well over 7% per annum. However, by the mid-1990sexports began to slow and overheating due to capital inflows was increasingly apparent. The government tried to constrain bank access to international capital through strict enforcement of net open positions and jawboning. However, there were no policy tools to restrict corporate borrowers from accessing international capital markets and from inflows through the non-bank financial sector. In particular Indonesian firms with revenues in rupiah directly accessed short maturity foreign currency loans in foreign markets. When the exchange rate depreciated dramatically these loans were unable to be rolled-over and unable to be paid. Many of these companies also had domestic loans and these too went unpaid. Economic problems spread to the banking sector leading to systemic failure and the economy contracted by 13% in 1998.

The poor economic response in Indonesia has been blamed on poor supervision and governance in the financial sector, especially banks and this was clearly a factor.[4] However, we feel that it was also due to underdeveloped non-bank financial institutions. High domestic interest rates and an inability to access domestic equity and bond funds prompted firms to turn to short turn foreign debt financing which led to currency and maturity mismatches. In some sense this was inevitable given the relatively late opening up of domestic non-bank financial markets and the amounts of international capital flowing

[3] Government employees have their own system.
[4] The political transition that occurred in the first half of 1998 also added to the depth of the crisis.

into Indonesia. In sum poor governance, insufficiently developed capital markets and globalized capital flows combined to make a difficult situation worse.

However, post crisis the situation is very different. Most of the largest national banks are now under new and often foreign or joint ownership, and the privatization of State Banks is now underway. This should lead to better governance and improved assessment of credit risk in the banking sector. We already see a different pattern of bank lending post crisis. It has been increasingly concentrated in the retail sector and smaller firms. This should leave non-bank financial institutions an increasing (and appropriate) role in supplying capital to domestic firms. The restructuring of corporations and the closing down of the government Bank Restructuring Agency (IBRA) is also winding up. IBRA held the assets, for example bank loans and more tangible assets from closed and recapitalized banks which were turned over to the government during the crisis. These assets have now largely been sold back to the private sector. Before these sale corporations with substantial debt to IBRA were not in a position to access capital markets. Now they will be, with legal certainty more corporations will be able to access capital. Indonesian corporations will also no longer have the kind of close affiliation with banks that existed pre-crisis. In response, bond issues by Indonesian corporates are increasing rapidly, multifinance companies are growing and IPOs are planned. Further the government itself is a major player in the capital market with auctions of government securities having begun this year.

There are a number of problems slowing the development of these sectors. On the demand side much of the population is still relatively poor and rural and relatively few people work in the formal sector where they would be expected to purchase capital market instruments or even have insurance or pensions. In addition given high interest rates and the ups and downs of other markets in recent years, individuals, pension and insurance funds have been very conservative in their investment strategies. However, this is changing, especially as recovery continues, awareness grows and interest rates fall. A more fundamental problem lies in the mistrust of many for non-bank financial products. This is in some part due to legal uncertainty and accounting and reporting rules but also includes concerns with insider trading, minority shareholder rights and corporate governance. These problems lead naturally to regulatory concerns. In every non-bank financial sector the government is committed to improving incentives to increase confidence and spur development, and these sectors feature in the policy agenda for 2004 and beyond.

Policy Directions

Capital market policy direction

The demand in the capital market will increase through improved market mechanisms, transparency on the part of listed firms and the introduction of new products.[5] The overall government objective is to improve information availability and reliability, legal certainty and operational efficiency. A key problem is the number of brokers that do not actively trade but hold seats on the Mutualized Burse. The immediate policy agenda is to increase the amount of paid in capital, and to demutualize the burse. This should consolidate the number of securities firms and improve incentives. We are also working to revise regulations to improve audit and disclosure issues for listed companies as part of a broader program to improve corporate governance. Due to recent rapid growth mutual funds are a particular priority, and we are revising regulations, reporting requirements and oversight. There will also be a focus on developing new capital market products including futures, options, asset backed securities and Syariah products to meet more sophisticated consumer demand

Insurance policy direction

The insurance industry faces some similar issues including a number of insufficiently capitalized firms. An amendment to the insurance law is being proposed that will increase capital requirements to supplement existing Risk Based Capital measures. New audit procedures to verify insurance and reassurance firms are being prepared. Fit and proper tests will be instituted, and an insurance guarantee institution created. Ministerial decrees will be brought into line with international best practice or IAIS core principals. A key problem is the lack of investment vehicles that allow an appropriate match of asset and liability maturities. Effective development in the capital market and the increased trading of government bonds should assist insurance companies find new and better uses for their capital.

Near term pension fund market policy direction

The role of the Indonesian provident fund, Jamsostek, is under review but the current system that provides basic pension (and other social) services with private sector employer (or financial sector) supplementary programs will be continued. The government

[5] In fact, as mentioned, declining interest rates and lengthening macroeconomic stability have already spurred increasing interest on the part of both domestic and foreign investors.

is committed to improving the training and certification of pension fund managers, including continuing education, revised rules on pension fund investment, improved governance and transparency in reporting. Again improvements in the overall capital markets are critical to allow pension funds investment vehicles with appropriate diversity and maturity structures. In particular the government will move to encourage pension funds to reduce their dependence on bank deposits. In return there will be an equal emphasis on encouraging firms listed on the stock market to add supplementary pension funds for their employees.

III. GLOBALIZATION: THE INSTITUTION BUILDING ROLE IN THE FINANCIAL SECTOR IN INDONESIA

The recent crises in Indonesia and in other emerging market countries have proved that the opportunities of globalization do not come without risks. Nevertheless, the issue is not to stop process of integration with the world economy, but rather how to best manage the process, that is the pace, the timing, the risks and the possible adverse effects of globalization. Thus, to better manage globalization with respect to the financial sector, both the central bank and the ministry of finance must play important roles.

a. *Central Bank Role*

The responsibilities of a central bank that also functions as a banking supervisory agent, among others, are to promote monetary stability, foster soundness of the financial sector, develop and implement adequate prudential regulations and effective supervision of financial institutions, as well as to provide adequate information to financial and other economic agents so as to minimize the scope for misinterpretation of economic circumstances and policies[6].

Regulation and Supervision

With regard to implementing adequate prudential regulations and effective supervision of financial institutions, Bank Indonesia has been setting targets to improve the supervisory framework, including, strengthening banking supervision and regulation, improving good corporate governance, and stimulating a sound banking environment.

[6] Ouattara, Alassane. “Globalization, Lessons from the Asian Crisis and Central Bank Policies”, Reunion des Gouverneurs des Banques Centrales des Pays Francophones, Ottawa, June 23 1998.

Weaknesses in the performance of banking supervision contributed to the recent banking crisis. To improve on this situation, Bank Indonesia has been focusing on the following aspects:

i. harmonization of bank supervision, particularly structure and responsibility
ii. betterment of bank supervision management, including but not limited to improving supervision efficiency and transparency, enhancement of supervisor competence, accountability and recognition, as well as reward and enforcement
iii. employment of risk-based banking supervision in accordance with 25 Basel Core Principles
iv. rectification of prudential regulations with emphasis on risk control.
v. enhancement of various banking regulations
vi. enhancement of the quality of bank management (good corporate governance) through the implementation of fit and proper tests, interviewing of prospective new bank managers, appointments of compliance directors, and submission of results of investigations into criminal offenses in the banking sector to the law–enforcement authorities.

To promote the conduct of good corporate governance, Bank Indonesia has introduced several rules:

i. to enhance the competence and integrity of the bankers through the implementation of *Fit and Proper Test* upon the bank's shareholders and management
ii. to require the bank to appoint a Compliance Director, holding the responsibility to ensure the bank's compliance with the existing regulations
iii. to hold up the consistency of law enforcement through the institution of Banking Investigation Special Unit, which is proposed to evidently discover the violations against banking rules in order to identify the root of the problem and coerce prompt repressive actions.

With regard to bank regulation, Bank Indonesia has introduced a new banking act (*Act No. 10 of 1998*) replacing the Banking Act No. 7 of 1992 and a new central bank act (*Act No. 23 of 1999*) replacing the Central Bank Act No. 13, 1968. These new acts were intended to improve the stability of banking system in Indonesia. Bank Indonesia also introduced the Act of Foreign Exchange Traffic and Exchange Rate System (*Act No. 24 of 1999*).

Banking Act No. 10 of 1998 cover, *inter alia*, the following items: (i) transferring the authorization on bank licensing from Minister of Finance to Bank Indonesia, (ii) relaxing the maximum of foreign ownership on Indonesian incorporated banks up to 99 percent, (iii) encouraging the development of Sharia Banking, (iv) narrowing of bank secrecy to cover, only, the information on deposits (name and amount) instead of the whole assets and liabilities, (v) adopting more comprehensive and stricter criminal sanction, and determination of the minimum level of criminal sanction, (vi) establishing a deposit protection scheme in 2004, at the latest, and (vii) establishing a temporary agency to assist the banking restructuring program.

The Central Bank Act also addressed the following items: (i) Bank Indonesia is provided with a broad capacity, authority, independence, and a single clear-cut responsibility to stabilize the national currency, (ii) the independence encompasses areas in legal, personnel, institution, objective, functions, management, budget, and transparency substances, (iii) Bank Indonesia is structurally positioned outside the Government hierarchy, holds full autonomy in performing its functions and cannot be intervened by the government and other parties, (iv) in line with the independence, Bank Indonesia is required to uphold accountability for its performance toward the public, as well as to the President and the Parliament, and (v) the banking supervision function will be vested with the independent supervisory agency, established in 2006 at the latest.

The Foreign Exchange Movement and Exchange Rate System Act provides a legal basis for the monitoring of the foreign exchange rate movement and the enforcement of prudential provisions. The Act requires banks to submit a report containing the movement of financial assets and liabilities between resident and non-resident to Bank Indonesia. Complete, accurate, and timely information of foreign exchange movement is the key information to support a prompt monetary policy response, which primarily is directed at preserving the stability of national currency, the single objective of Bank Indonesia.

Technology

It is undeniable that information and communication technology plays an important element in strengthening the role of institution building in the financial sector. There is a belief that a fundamental cause of the recent crisis was that both the government and the private sector failed to adapt to the changing environment of the global economy, namely the revolutionary progress of information and communication technology.

To accomplish one of its tasks, i.e. maintaining a well-functioning payment system in Indonesia, Bank Indonesia needs to keep up with information and communication technology. To maintain a well-functioning payment system, as well as to enhance information and communication, Bank Indonesia in 1987 started to develop a computer-based accounting system. The accounting application system at Bank Indonesia's headquarters is known as the Bank Indonesia Accounting System (BIASA), while in Bank Indonesia's other offices the application system is known the Automated Accounting System (OSA). These programs were initially designed to operate independently, and not to be integrated with other program. However, the long-term plan to develop a computerized accounting system included a second phase plan to develop an integrated online system between Bank Indonesia's accounting system and all banks.

The development of the BIASA and OSA programs started in 42 offices of Bank Indonesia in July 1989 and was completed in 1994. In the plan's next phase, , Bank Indonesia began developing an application for funds transfer among all Bank Indonesia's offices, which was later know as SAKTI (Automated and Integrated Intra-Office Funds Transfer System). Through this system, Bank Indonesia's intra-office funds transfer now was done with an electronic delivery system, instead of using the mail system, telex, and telephone. The application of SAKTI was completed in February 1997, a year and half after the program started in November 1995.

When Bank Indonesia's headquarters and branch offices were connected through SAKTI, development began on an online system that would connect Bank Indonesia and other banks. This application later became known as BI-LINE. The online connection would enable banks to transfer their funds to other banks electronically through their reserve account in Bank Indonesia. This was a step forward in efforts to make banks comply with setting their inter-bank payment.

The idea to develop BI-LINE, which was started in April 1996, coincided with the completion of the blueprint of the National Payment System, which aimed at the development of the Inter-bank Electronic Funds Transfer System (IBETF) using the Real-Time Gross Settlement (RTGS). BI-LINE as a matter of fact could only provide simple technical solutions for the electronic inter-bank transfer, and this was considered normal since Bank Indonesia had only begun to learn about the payment system concept as a whole in 1995. The need to implement BI-RTGS is primarily to enhance the quality of payment services by making effective, efficient, accurate, safe and reliable payments. Other considerations that argued for implementing BI-RTGS, a are that it would enable banks to: (i) manage their cash flow across Indonesia optimally, (ii) manage and minimize intra-day liquidity needs, (iii) prioritize and manage payment orders, and (iv) maximize the use of internal banking systems and networks to reach maximum solutions. Aside from providing a system/application solution, BI-RTGS must also create the environment for self-regulatory banks, and the condition that enables all banks to have the same authority to do electronic funds transfer and comply with the inter-bank regulations agreed jointly by the banks. Hence, the application of BI-RTGS sprung from the needs to minimize the risks of the payment systems.

The BI-RTGS which began to be implemented in November 2000 in Jakarta has grown tremendously from 12 cities in 2001 to 27 across Indonesia in 2002. In conducting the inter-bank fund transfer system, Bank Indonesia has passed Bank Indonesia Circular Letter No. 2/24/DASP as amended by Bank Indonesia Circular Letter No. 3/20/DASP concerning Bank Indonesia Real Time Gross Settlement (BI-RTGS). It regulates BI-

RTGS's mechanism, a type of transaction, BI-RTGS's participant, participants' status: active, suspend, freeze, and closed, BI-RTGS window time, infrastructure specification, and rights and obligations of participants. This system handles electronic credit transfer items, except for Bank Indonesia transactions; it includes electronic debit transfer items that have a high value (above Rp.1 million) and are urgent.

Meanwhile, in conducting the inter-bank local clearing system, Bank Indonesia passed Bank Indonesia Regulation (PBI) No. 1/3/PBI/1999 as amended by PBI No. 2/14/PBI/2000. This provided for four local clearing systems: manual, semi-automated, automated and electronic clearing systems. These systems handled paper-based clearing items, such as cheques and credit transfer notes that have a low value (below Rp. 1 million).

Debit and/or credit clearing instruments from tone local clearing area could not be processed in other local clearing areas. To overcome this limitation, major banks provide "inkaso" clearing instrument service or intra-bank transfer service through their own internal bank facilities. This situation was unfavourable for banks, public and Bank Indonesia, as it reduced service quality for customers; increased transfer costs; entailed a relatively long settlement period; and led to uncertainty concerning the funds. Overall, it was an inefficient part of the national payment system. Thus, to rectify this problem, the inter-city clearing system was developed on October 1, 2002, which allows banks to clear their notes with clearing operators in any area. The development of the inter-city clearing system is possible due to the technology owned by banks, which enables on-line verification of out-of-town cheques/BGs. The implementation of intercity clearing is expected to give benefit to public, banks particularly for inter-city payment using cheques/BGs.

Human resource development in Bank Indonesia

Bank Indonesia is aware that human resources remain an integral part in establishing a sound institution. To this end, Bank Indonesia has made several improvements both in the *quantity* as well as *quality* of its human resources.

With regard to quality, a professional staff with high integrity remains the main objective of the Board of Bank Indonesia in order to realize a respected and credible central bank. This is an on-going effort, made by improving the human resource management system. The total number of Bank Indonesia employees declined from 7,776 persons in March 1995 to 5,448 persons in August 2003. Lower-level staff was reduced, in line with needs for a smaller and more dynamic organization. However, the number of employees with higher education and advanced job-descriptions increased. Out of 5,465 persons, 2,971 of them were posted at the head office, 2,480 at the regional offices, and 14 at the representative offices abroad.

To improve the quality of Bank Indonesia's personnel in the banking system, Bank Indonesia has taken several steps namely:

- establishing a Centre of Education and Central Bank Studies (PPSK) with the aim to improve the quality of the research work in the banking sector;
- preparing a draft on human resources development in the banking sector so as to support the plan to transfer authority over banking supervision from Bank Indonesia to a new independent body as stipulated by Act No. 23 of 1999 article 34 on Bank Indonesia;
- developing a concept for a more focused Sharia banking sector so as to encourage the trend in domestic banking of moving from conventional banks to Sharia banks;
- improving the Human Resource Management System, including the enhancement of the professionalism of human resource functions supported by man to job fit personnel in accordance with work units needs.
- Requiring members of the Board and other high ranking Bank Indonesia officials to submit formal reports on their assets and wealth in order to create an institution free of corruption, collusion, and nepotism.
- Reorganizing the internal management of the banking sector so as to be more focused on planning and supervising.

NUMBER OF PERSONNEL

No.	End of Financial Year	Head Office	Regional Offices	Representative Offices	Total
1	1994/1995	4,199	3,521	56	7,776
2	1995/1996	4,145	3,483	70	7,698
3	1996/1997	3,292	2,987	95	6,374
4	1997/1998	3,341	2,882	67	6,290
5	1998/1999	3,299	2,852	21	6,172
6	1999/2000	3,068	2,601	17	5,686
7	2000/2001	3,123	2,615	18	5,756
8	Jan 2002	3,119	2,556	18	5,693
9	Aug 2003	2,971	2,485	14	5,448

b. *The Government Role*

Clearly the lesson pre-crisis and during the crisis itself have been on the importance of institutions and incentives in the financial sector. A series of sequenced reforms in the

NBFI sector, beginning over 10 years ago has resulted in a much greater global exposure for the Indonesian firms and the financial sector. This has had both positive and negative consequences. On the positive side growth has been faster and foreign involvement deeper than would otherwise have been achieved. On the negative side some of these industries expanded faster than their regulatory, human and technology support base. This in turn contributed significantly to the crisis in 1997 and subsequent slow growth.

Currently Indonesian NBFI regulatory agencies review best practice; cooperate in bilateral, regional and international forums; and review technology changes. They are also working to promote the development of human resources among the market players, especially in the areas of licensing procedures and exams by professional standard committees. The overall strategy is to put in place better regulatory regimes, improved technology and upgraded training to improve the institutional base in anticipation of phased increases in regional and global integration. Post-crisis financial constraints have limited funds but priorities within limited budgets have gone to improving regulatory procedures and training for investigators. Additional support fees are programmed for 2004 and we expect that more extensive human resource development program for regulators can be put in place by 2005.

In a nutshell the GOI strategy for the NBFI sector to adopt to and prepare for globalization is as follows:

1. Consolidate the players and improve the regulatory regime, including through reorganization at the Ministry of Finance and an integrated financial sector supervisory institution,
2. Improve the funding and capacity of regulatory authorities,
3. Allow increasing foreign participation within the financial sector, and
4. Gradually integrate with the rest of the region.

IV. THE NEED FOR FURTHER INSTITUTIONAL CHANGES

Bearing in mind the beneficial properties of globalization on one hand and taking into account that weaknesses in the Indonesia’s financial sector still exist, the Indonesian authorities have been trying to improve further its institutions so as to enable it to keep up with the pace of globalization. Such improvement is done at both national level as well as international level.

a. Banking Sector

National Level

At national level, there are two priority areas, i.e. the need to establish a deposit insurance institution and a supervision institution for the financial services sector.

i. Deposit insurance

In an effort to maintain the stability and resilience of the national banking system, a mechanism needs to be created to maintain public confidence in banking system. One of the supporting instruments will be the availability of a financial safety net, which can provide assurance concerning the protection of customer funds in the event that a bank fails to fulfill its obligations. The high costs resulting from diminishing public confidence was demonstrated after the liquidation of 16 banks in 1997 which resulted in runs on bank deposits. The lack of an explicit guarantee on public saving funds was one factor causing that bank run. To stabilize the situation, the government provided a blanket guarantee in order to regain public confidence in the banking sector. The government guarantee policy is regulated in Presidential Decree number 26/1998, which is further regulated by Minister of Finance Decree number 197/KMK.017/2000.

The policy to provide a blanket guarantee proved effective in regaining public confidence[7]. Within a relatively short time, public funds flowed back into the banking systems, and currently total public savings have reached approximately 70 percent of total bank assets. However, behind this success is the large burden that has to be borne by the government and the potential emergence of moral hazard in the future in the banking sector. To rectify this situation, it would be helpful to formulate a more effective guarantee of customer savings. The concept of a limited guarantee, such as deposit insurance that is used in several countries, is one alternative.

With this background, a Working Team (comprising representative from Bank Indonesia, the Ministry of Finance, and IBRA) has been appointed with the task of preparing for the establishment of the deposit insurance institution (LPS). The focus of this Working Team is divided into two parts. The short-term agenda is to *formulate a phasing-out for the guarantee coverage on almost all bank obligations*; it would be limited to savings, collections, incoming/outgoing transfers, inter-bank lending, and Letter of Credit.

Meanwhile, the long-term agenda is to *make preparations for the establishment of deposit insurance institution*, using an insurance scheme with limited guarantee coverage. Several specific criteria for the deposit insurance institution also need to be determined including, institutional status, premiums, and membership.

[7] Bank Indonesia, Annual Report 2001, 2002

To enable LPS to execute its tasks effectively, there needs to be a guarantee of its independence in executing its tasks and authority. It is expected that the LPS would be a legal entity outside the government, accountable directly to the Parliament. With regard to the determination of the guarantee premium, for the time being, a flat-fee pattern will be adopted. It is planned to impose risk-adjusted fees soon to reflect different risks, objectively assessed on each of the banks. The membership of the LPS will be compulsory for all banks operating in Indonesia, including foreign banks, to ensure equal business opportunities.

The establishment of LPS of course will take into account several prerequisites, including the existence of a sound and stable banking system. In line with this prerequisite, bank restructuring needs to be continued. It is expected that a period of 3 years from 2001 will be sufficient for making preparations for the establishment of this institution, and as such 2004 is considered the right time to start applying guarantees based on LPS.

ii. Supervision institution for the financial services sector

Article 34, Act 23 of 1999 concerning Bank Indonesia, calls for the establishment of a new institution for consolidated supervision of the financial sector. In accordance with this mandate, the bank supervision function will be transferred from Bank Indonesia to this new independent institution, which was to be established before 31 December 2002. With the transfer of this supervision function, Bank Indonesia will only function as the monetary authority with its main task focused as the monetary and payment system issues. The idea of segregating the bank supervision function and transferring it from the central bank to another institution is not a new one in the banking supervision practice in other countries.

Although institutionally the bank supervision function will be given to a new institution, Bank Indonesia still has the authority and responsibility for maintaining overall financial system stability. Bank Indonesia’s function in maintaining financial system stability related to banks and other financial institutions will involve handling systemic risks faced by banks as well as the overall financial industry. Systemic risk involves risks faced by several banks, which have the potential to spread instability throughout the entire banking and financial industry. Consequently, its handling must be conducted on a macro basis. The new Supervision Institution for the Financial Services Sector will put more emphasis on micro aspects of banking, namely prudential regulations in terms of individual banks and non-bank financial institutions compliance with all prevailing stipulations.

Structure wise, the new Supervision Institution for the Financial Services Sector is planned to be a government institution outside the cabinet, which is accountable to the President. The objective of the establishment of this institute is to undertake supervision over all institutions providing financial services in the framework of creating a healthy, accountable and competitive financial services industry. The coverage of the tasks of the new institution will include the supervision of banks and all non-bank financial institutions, such as insurance, venture capital companies, pawn companies, leasing companies, pension funds, security companies, and other financial services companies, including public fund managers.

Currently, supervision of the various financial services companies is conducted by various institutions which are not integrated. For example, the authority for the supervision of banks is under Bank Indonesia, the authority for the supervision of security companies is under the Capital Market Supervisory Board (Bapepam), and the authority for the supervision of insurance companies is under the Minister of Finance. The existence of many different financial services supervisory institutions, in some cases, has caused overlapping authority and inefficiencies in coordination among these institutions. In addition, the relationship between banks and non-bank financial institutions is very close with similarities in business operations and risks. With the establishment of one institution that supervises overall financial services, it is expected that supervision over those institutions can be more efficient and conducted in a consolidated and integrated way, which in the end will be more beneficial for all stakeholders.

Conceptually, the Supervision Institution for the Financial Services Sector will not only have authority to supervise, but will also have the authority to regulate, including to issue and revoke business licenses of financial service management institutions. In addition, to ease investigation of illegal practices in the financial sector, the new institution will also be given the authority to investigate, such as that held by other law-enforcement apparatuses, although this authority would be limited to the financial sector. With the plan to terminate Bank Indonesia's function in these areas, there is a need to amend Act 7 of 1992 concerning banks as amended by Act 10 of 1998.

A team comprising members from the Ministry of Finance, Bank Indonesia, the Capital Market Supervisory Board, and the Department of Law, assisted by consultants from ADB, have been working for two years to formulate the review and concept of the new financial service supervisory authority. Up to now, the team has succeeded in developing the blueprint for the establishment of the Supervision Institution for the Financial Services Sector as well as a draft law concerning this new institution. It is expected that the draft act will be submitted for approval in 2003 so that, by 2006, it can be enacted as law and the institution can be established. After the institution is established, the transfer of banking supervision and regulation from Bank Indonesia to the new institution will be done gradually. Consequently, preparations will be needed in Bank Indonesia and in the new institution, particularly concerning systems, data/information, and human resources in order for the transfer process to run without disruptions.

International Level

Efforts to further strengthen institutional building at international level are done by meeting the international standard requirements.

Globalization indeed caused a rapid development in the banking instruments and facilities. Nevertheless, development of banking products, as well as their potential problems, signals the need to continue strengthening banking supervision in compliance with international standards. The Basel Committee released a document titled *"25 Basel Core Principles for Effective Banking Supervision"* in September 1997, which basically provides key principles to be used as guidelines in the framework of strengthening domestic and international financial stability.

Bank Indonesia has supported the Bank for International Settlement (BIS) efforts by conducting a self-assessment of its compliance with the Core Principles (CPs). To ensure objectively, Bank Indonesia also requested IMF assistance in performing a similar assessment. The synergy of these assessments is expected to support the sequencing of priorities and directions of IMF assistance to further enhance bank supervision regulations and procedures. The IMF assessment was finalized in July 2003. It indicated that Bank Indonesia is fully compliant with 2 CPs, namely CP1 "preconditions for effective banking supervision" and CP2 "permissible activities". As regards the other core principles, Bank Indonesia is categorized as largely compliant with 14 CPs, materially non-compliant with 8 CPs , and non-compliant with 1 CP.

In order to increase compliance, Bank Indonesia initiated a comprehensive assessment of its banking supervisory regulations and banking supervision process. This diagnostic assessment was used as the foundation to prepare a comprehensive banking supervisory plan, namely the Bank Indonesia's Master Plan. This Master Plan was intended to provide a framework for the implementation of the broad reform efforts necessary to establish a bank supervisory process that fully incorporates international standards such as those outlined by the Basel Committee on Banking Supervision in its 25 Basle Core Principles (BCP) document. The BCPs provide the overall framework underpinning the Master Plan. Bank Indonesia's objective is to fully comply with the BCPs by the end of 2004.

Efforts to enhance good corporate governance (GCG) in the banks started in 1999 through the establishment of the National Policy Committee For Corporate Governance. The main task of this committee is to formulate and develop recommendations for national policies on corporate governance, covering guidelines on GCG, details on enhancement of legal instruments and the structure of institutional support. Specifically concerning the banking industry, GCG is undertaken through the fit and proper tests on bank owners and management, interviews with potential bank owners and management (new entries), appointments of compliance directors, and investigations into criminal practice in the banking sector.

b. *Non-Bank Financial Institution Sector*

While the Non-Banking Financial Institution sector includes a variety of areas with distinct characteristics and policy agendas, it is unified in the sense that the Government of Indonesia is committed to broadening and diversifying the role of each of these sectors to increase the efficiency and amount of financing available for development. These sectors are also unified in the sense that each faces similar opportunities and challenges due to increasing regional and global integration. These challenges and opportunities become the driving force for institutional change in the non-banking financial sector.

First, this involves broadening the scope of alternatives to bank saving and lending. The urgency for this has increased in the aftermath of the crisis in 1997. Post mortems indicate that poor governance and an excessive reliance of Indonesian corporations on debt (and especially foreign denominated debt) contributed substantially to the depth of the economic crisis. A domestic capital market that is more open, more diversified, less leveraged, will result in a corporate finance structure that is more efficient and resilient in the face of future crises. The crisis also demonstrated the importance of reliable, diversified insurance and pensions as these have also had to be tapped. Again more and more diversified options are needed. This must be matched by investors who understand and accept the inherently differential risks and maturities involved in different instruments. The government must provide a regulatory framework and institutional structure that has the appropriate incentives, including incentives for transparency and governance.

Second, the crisis also left the government with a large amount of domestic debt. This debt, taken on to recapitalize the banking system, now coming due will need to be refinanced. Annual amounts coming due may well be in the range of the entire capitalization of the bond market pre crisis. In addition the Indonesian Parliament has mandated that the government reduce its reliance on foreign financing. Henceforth the central government will be a major actor in domestic financial and especially capital markets. This itself presents opportunities, to establish a well defined yield curve for example, and risks depending on the depth and liquidity of the resulting market.

Third, the Indonesian workforce is demographically young, but these demographics are changing and birth rates are falling rapidly. It is important that insurance and pension products are developed to support the work force in their old age.

Fourth, Indonesia is significantly decentralizing government authority. This includes allowing regional governments, under certain conditions, to access financial markets. In particular, both the central and regional governments will need access to domestic capital markets for marginal and long term project financing The development of stronger domestic capital markets should allow for a better maturity match and reduce financing costs for regional governments.

Finally, as elsewhere technology is rapidly increasing the sophistication and awareness of consumers. This inevitably means increased international competition for domestic providers of financial services. With or without regulation, internet driven services are increasingly a substitute for domestic provision. Against this background, the government is committed to working with the domestic industry to improve the institutional architecture, to remove barriers to improve financial services to meet this challenge without sacrificing the needs of consumers and firms and especially their need to access international markets. This access is critical to the development of a deep and well-balanced corporate structure. Thus despite the risks that globalization brings the government's approach is to allow increased competition with international providers, both within Indonesia and outside. This stance is adopted in full awareness of the risks and challenges that access to foreign capital bring. The rapid turn around in capital flows, and the consequences that result, are still fresh in everyone's mind.

Financial markets in Indonesia already have a significant and rapidly growing foreign presence. With the implementation of AFTA, the integration of the ASEAN markets, we are committed to a staged opening of financial sectors to our partners in the region. We need to anticipate this development with international best practice regulations. While Indonesia is a large market it is one that is very open to trade and already significantly integrated with financial markets in Singapore and beyond. If we do not meet the challenge our consumers and firms can and will move their business elsewhere. Effective market friendly regulation in an open environment is the best choice.

However, there are consequences to the rapid movement of capital and these consequences often fall on those not directly involved. To prevent this, those involved in investing should face the consequences of their actions. We are working to put in place an institutional environment in the financial sector that will reduce implicit guarantees and allow actors to find and accept their own risk levels. The best defense is strong macroeconomic policy, fiscal discipline, effective banking supervision, a good legal system and strong and diversified non-bank financial institutions. Putting these in place is obviously a difficult task and a longer term goal. However, as recovery continues and financial institutions grow it is important that they grow based on solid foundations. Hence, with the macroeconomic situation in Indonesia stabilizing and the fiscal position back on a sustainable footing, reform in the financial sector, and perhaps especially in the Non-bank Financial Sector are now at the top of the government policy agenda. As recovery occurs we want to build it on the basis of strong financial foundations. Globalization brings many benefits, but it can also bring instability. It is important that institutional foundations are strong enough to resist the instability, or if they succumb that they recover quickly.

V. LESSONS TO BE LEARNED

The process of Indonesia's economic integration into the world economy has taught us valuable lessons to improve our economy's efficiency and resilience in the future. As it is often true in many cases, problems and crisis also bring with them opportunities. Among the opportunities associated with the crisis are the opportunity to look back and re-examine very closely what is lacking and what needs to be done to strengthen the foundation for growth. With regard to this, there are several lessons to be learned from globalization, namely:

- **First**, though it is undeniable that globalization bestows prosperity to the economy and creates modern economic states through the increasing access to foreign private capital, technology, and entrepreneurial talents; we learned a clear lesson that some countries particularly developing countries can not reap fully the benefit of globalization without strong financial infrastructures.
- **Second,** the reason that Indonesia's economic integration into the world economy could not be fully enjoyed because it is not supported by well developed institutions including well-regulated set of financial institution as a prerequisite for the operation of an efficient market economy.
- **Third,** to be able to best manage globalization, the Indonesian government has taken the opportunities to redefine the role of the central bank. To this end, the central bank makes efforts to establish sound regulations and effective supervision of financial institutions, to restructure the banking system, to introduce or amend the bankruptcy law and the law on competition, as well as to provide adequate information to financial and other economic agents through the use of technology.
- **Fourth**, a central bank should also provide ample supervision with highly qualified supervisor. It is evidence that since the institutional liberalization of October 1988, the capacity of the supervisory authority has not been able to match the pervasive growth of banking industry. With 240 commercial banks (with their more than 6,000 branches) and more than 9,000 rural banks, the approximately 700 supervisors were far from sufficient in terms of both quantity and quality.
- **Fifth**, there is a question about sequencing and timing of the measures of financial liberalization. For Indonesia, institutional liberalization was introduced long before (i.e. in October 1988) measures for strengthening prudential regulations (in February 1992), causing difficulties in enforcing such prudential measures especially since the growth of banking business had already been pervasive.
- **Sixth,** The institutional liberalization of October 1988 put too much emphasis on easing entry requirements and procedures into the banking industry. The exit mechanism, on the other hand was not properly designed. This was aggravated by

the absence of some form of deposit protection scheme, especially for the majority of depositors with small amounts of deposits. Fearing systemic risks from closing a bank, in a centralized and autocratic economic and political system, forced the authorities to nurture problem banks instead of enforcing a strict exit policy. This form of an implicit guarantee from the authority created moral hazard in the banking system.

∉ **Seventh,** the underdevelopment of non-bank financial markets, especially capital, was caused by and contributed to the problems in banking. Mismatches in maturity and currencies in the banking system would have been better handled with a better developed capital markets. However, conglomerate banks and corporations reduced the attractiveness of capital markets as well creating a vicious circle. A more comprehensive approach might have worked better. Developing capital (bond and equity) markets is now a key government priority.

∉ **Eighth,** the potential for asymmetric information is even greater in capital markets and thus more certainty in property rights and transparency is required. This leads directly to the development of legal and accounting systems and their enforcement which have also been problems. These areas have also been prioritized for continuing reform.

∉ **Ninth**, Insurance and pension funds were more recently opened to global markets. The issue here is the rapid progress of technology and the importance of building up institutional and regulatory capacity to avoid the sorts of problems faced in banking. This requires rationalizing the industries and opening them further to foreign providers, while gradually integrating them into larger regional markets.

VI. CONCLUSION

We can now ascertain the role of globalization in Indonesia's financial sector. For the period prior to crisis, a series of liberalization in Indonesia's financial sector particularly in the banking sector was driven from domestic needs; while for the post-crisis period, the reform mainly stemmed from the integration of Indonesia's economy to the world market.

It is undeniable that integration with the global economy will improve the country's economic performance since it provides for wider access to the global financial market. Nevertheless, it is also clear that alongside the new opportunities in finance and trade offered by the increasingly open, integrated, and competitive global economy, new challenges to strong institution building have also emerged.

Central banks and other financial regulators play a vital part in setting conditions for a country to benefit from globalization. This is done by ensuring the soundness of the financial system. Strong financial infrastructure, including the institutional framework strengthens the financial sector so as to make it less susceptible to either internal or external shocks.

The Indonesian experience in and since the crisis and the challenge of economic globalization has motivated the Government to focus on the institutional foundations of our financial system. In response our key effort is to develop a comprehensive Financial Safety Net (FSN). This FSN, designed by a team from the Ministry of Finance (MoF) and Bank Indonesia (BI), is aimed at developing a Financial Service Authority (FSA) and Deposit Insurance Company (LPS). This FSN is one of three key Government priorities for the next year as we move to establish a safer and sounder national financial system. We know the consequences of a financial crisis and we want a system that provides improved incentives to avoid or mitigate a future crises.

The Indonesian Government believes that an integrated, efficient, and effective FSN would provide clear lines of authority and responsibility among the major financial oversight institutions. We envision the MoF as the fiscal authority, BI as the monetary authority (with responsiblity for financial stability analysis, the payment system, and lender of the last resort), the FSA as a comprehensive financial service regulator and supervisor; and LPS as the guarantor of bank depositors.

Furthermore, from the monetary side, central bankers are responsible for promoting monetary stability and fostering the soundness of the financial sector. Central banks have a key role to play in developing and implementing adequate prudential regulations and in the effective supervision of financial institutions, as well as maintaining close coordination and collaboration with the supervisory agencies. Furthermore, to be able to ensure that the banking sector benefits more strongly from globalization, central banks need to build sound institution and policies that support and complement the expansion of banking sector.

At the same time the government is committed to expanding the role of the capital market in providing financing to improve maturity and risk profiles. Along this line, a number of efforts are being pursued, which include increasing demand for equities and bonds by improving the market mechanism, increasing the transparency of listed firms and introducing new products as well as overcoming remaining constraints. In particular the government is prioritizing eliminating inactive securities companies by increasing the amount of paid in capital and demutualizing the burse. Moreover revisions of regulations to improve audit and disclosure rules for listed companies as part of broader program to improve corporate governance are alos in progress. Finally, there is a focus on developing new capital market products to meet more sophisticated consumer demand.

A key problem facing our rapidly growing insurance and pension industries is a lack of investment vehicles that allow an appropriate match of asset and liability maturities. This should be improved by effective development in the capital market and increased trading of government bonds. However again we are looking to promote consolidation and raise the capacity of practicioners and regulators to create a healthier and more competitive enviroment as regional integration proceeds.

With such a commitment to creating a strong comprehensive foundation for the national financial system Indonesia would be able to compete in financial globalization. Still we are aware of the consequences of misteps and faulty sequencing. To the build up of problems we intend to monitor reforms and integration continously. In pricipal, we want to work with not against globalization.

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