THE CAPITAL MARKET IN INDONESIA'S ECONOMY: DEVELOPMENT AND PROSPECTS

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INTRODUCTION

Alongside distribution of income and resources and price stabilisation, the growth rate of an economy is an important macro indicator of economic development. Economic growth usually requires a proportional increase in investment. At the same time, because higher economic growth indicates improving macroeconomic performance it will encourage investment. Indonesia's economy should have grown without many obstacles in the environment of economic globalisation and flourishing domestic business activity during the 1990s. But the economic crisis that hit in the middle of 1997 obliterated this expectation. The improved macroeconomic performance achieved by Indonesia (which had been listed by the World Bank among the countries with rapid economic growth) collapsed since the crisis. One factor impeding the revival of the business sector was its excessive dependence on bank funding. The relative under utilisation of the capital market for financing Indonesian business delayed the recovery of the national economy from the crisis.

This chapter describes capital market development in Indonesia and the role of capital market financing in Indonesia's economic development.

INDONESIA'S ECONOMIC DEVELOPMENT IN BRIEF

Indonesia made good macroeconomic progress, growing more than seven percent per year on average for the five years before the economic crisis in struck 1997 (Table 1). This was one of the highest rates of growth in the emerging economies in Asia. Monetary policy was directed to maintaining internal and

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external stability, and inflation had subsided to a safe level. During that period, prudent government policy planning to control expenditures generated continual fiscal surpluses. On the external side, current account deficits were below four percent of GDP, the lowest ratio in Southeast Asia. The current account deficit resulted from the growth of imports, particularly investment goods, tied to the high level of economic activity. Until mid 1997 it seemed possible that Indonesia would be able to reduce the current account deficit in the coming years since exports, especially non-oil and gas exports, were increasing. This favourable outlook was due to the government's integrated macroeconomic policies that had been undertaken to maintain stability and to support high economic growth.

TABLE 1
Growth Rate of Real GDP by Industry at Constant 1993 Prices, 1993-2001
Percent

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Agriculture, livestock, forestry and fisheries	1.7	0.6	4.4	0.1	1.0	-1.3	2.7	1.7	0.6
Mining and quarrying	3.4	5.6	6.7	6.3	2.1	-2.8	-2.4	2.3	-0.6
Manufacturing	11.4	12.5	10.9	11.6	5.3	-11.4	3.8	6.2	4.3
Electricity, gas and water supply	10.1	12.7	15.9	13.6	12.4	3.0	8.3	8.8	8.4
Construction	14.5	14.9	12.9	12.8	7.4	-36.4	-0.8	6.7	4.0
Trade, hotels and restaurants	8.8	7.3	7.9	8.2	5.8	-18.2	0.1	5.7	5.1
Transport and communication	9.9	7.8	8.5	8.7	7.0	-15.1	-0.8	9.4	7.5
Financial and leasing and business	10.3	10.2	11.0	6.0	5.9	-26.6	-7.5	4.7	3.0
Services	4.3	2.8	3.3	3.4	3.6	-3.8	1.9	2.2	2.0
GDP	7.3	7.5	8.2	7.8	4.7	-13.1	0.8	4.8	3.3

Source: Central Bureau of Statistics.

The outlook changed significantly as the speculative attack that started in Thailand in July 1997 quickly hit other Asian currencies, including Indonesia's rupiah. The exchange rate fell from 2,410 rupiah to the U.S. dollar on 11 July 1997 to around 8,550 on 8 April 1998. This drastic weakening of the rupiah showed the negative response of the markets to the government's efforts to restore currency stability. The weakness of the rupiah was closely related to speculation by certain foreign financial institutions aimed at destabilising regional economic performance, particularly the reform commitment undertaken by Indonesia, which was actively supported by international agencies, namely the IMF (International Monetary Fund), the World Bank, and the ADB (Asian Development Bank).

The government of Indonesia undertook a number of measures to stabilise the exchange rate and economic conditions. However, the excesses of the national general election campaign in 1999 obstructed production and investor expectations. Rising nationalism together with various distorted, non-transparent policies caused many investors to cancel their plans to invest in Indonesia. Increased scepticism about changes in political and economic policy cut into the realisation of investment plans and, eventually, economic growth. These uncertainties in addition to unsolved bureaucratic problems and the problematic banking system undermined the sustainability of long-term economic growth.

Indonesia's economy started to recover and strengthen with more balanced growth in 2000 (Table 1). GDP grew 4.8 percent compared to 0.8 percent the previous year and to -13.1 percent in 1998. All sectors in the economy recorded positive growth. The processing industry still represents the main engine of growth, followed by the trading and transportation sector. The financial sector, which contracted in 1998 and 1999, also recorded positive growth. On the demand side, economic recovery is being sustained by investment spending. In 2000 the generator of economic growth shifted from consumption to exports and investment, both of which contributed significantly and positively to GDP growth (Table 2).

TABLE 2
Growth of Real GDP by Expenditure at Constant 1993 Prices, 1993-2001
Percent

	Real GDP	Consumption	Investment	Exports	Imports
1993	7.3	8.3	6.6	6.1	4.2
1994	7.5	10.1	13.8	9.1	14.5
1995	8.2	8.6	14.0	8.6	15.8
1996	7.8	8.9	14.5	7.6	6.9
1997	4.7	5.9	8.6	7.8	14.7
1998	-13.1	-7.1	-33.0	11.2	-5.3
1999	0.8	4.3	-9.4	-31.6	-40.7
2000	4.8	3.9	17.9	16.1	18.2
2001	3.3	6.2	4.0	1.9	8.1

Source: Central Bureau of Statistics.

Investment spending increased seventeen percent in 2000, a significant development considering that it was still contracting the previous year. The increase in investment performance indicates that the economic recovery is already on the appropriate path, and continuing and increasing investment spending should push up the rate of economic growth. Investment is especially attractive in view of the fact that at current share prices (which are quite low in U.S. dollar terms) companies would not lose substantially even if the most disastrous political chaos should occur. Moreover, there is great potential for profits to multiply when political conditions improve in the future.

Nevertheless, Indonesia's economy slowed in 2001. GDP managed only 3.3 percent growth, compared to the targeted rate of 5.0 percent. This deceleration was attributable to unfavourable internal developments as well as to the global economic slowdown. Domestically, debt and corporate sector restructuring progressed slowly, banks were consolidating, and the government had a heavy financial burden. The demand-side sources of economic growth, investment and exports, did not develop as expected in 2001 because of continuing risk and uncertainty related to the rising social and political tension and to weak law enforcement. Economic growth mainly depended on consumption by the household and government sectors.

For 2002, Indonesia expects GDP to grow 3.5 percent. Although progress has been made in the settlement process for the government's foreign loans and on bank re-capitalisation, several fundamental economic problems continue to obstruct the recovery. These are mainly the many constraints against acceleration of private investment, the delayed restructuring of private enterprises and foreign debt, the non-recovery of financial intermediation by banks, and the government's limited capacity for fiscal stimulus because of substantial expenditures for loan interest and subsidies.

The economy's continuing structural problems and uncertainty have caused increased inflationary pressure. Such structural problems as the obstruction in bank intermediation keep aggregate supply from increasing sufficiently to satisfy the strong aggregate demand. The government policy to reduce subsidies, the weakening rupiah exchange rate, and high inflationary expectations add to the pressure on prices. The inflation rate climbed to 9.35 percent in 2000 compared to 2.01 percent in 1999, and it reached double digits in 2001 (Table 3).

TABLE 3
Annual Inflation Rate, 1991-2001

	CPI Inflation Rate %
1991	9.54
1992	4.93
1993	9.77
1994	9.25
1995	8.65
1996	6.47
1997	11.05
1998	77.63
1999	2.01
2000	9.35
2001	12.55

Source: Central Bank of Indonesia

This current combination of economic conditions makes it difficult for Bank Indonesia (BI, the central bank) to formulate and implement monetary policy. On one hand, the increasing inflationary pressure demands tight monetary policy, while on the other hand, tightening monetary policy too drastically would threaten the banking recovery and the restructuring of still unstable companies. The failure of these companies in turn would destroy public confidence in the economic recovery, which would eventually accelerate inflation further.

SOURCES OF FUNDS FOR INDONESIA'S ECONOMIC DEVELOPMENT

An economy's pace of development is generally influenced by both external and internal factors. The internal factors include the direction of economic policy, the degree of economic development activities, and the availability of funds to finance economic development. The four main sources of public and private sector funds for Indonesia's economic development are the State Budget (APBN), foreign loans, bank loans, and the capital market (Table 4).

TABLE 4
Sources of Funds for Indonesia's Economic Development, 1991-2001

	State Budget (APBN) Rp trillion	Foreign Loans US$ billion	Bank Loans Rp trillion	Bond and Share Issues Rp trillion
1991	22.0	65.7	113.6	11.2
1992	25.9	73.4	123.7	15.0
1993	27.3	80.6	148.3	21.8
1994	27.6	67.6	188.9	33.2
1995	28.3	106.4	234.6	44.1
1996	33.1	109.3	293.0	61.5
1997	39.0	136.1	378.1	89.6
1998	71.6	150.9	545.4	94.8
1999	61.8	148.1	277.3	229.9
2000	41.6	141.7	320.4	254.8
2001	43.1	131.2	358.6	263.0

Source: Central Bank of Indonesia

State Budget (APBN)

Originally, APBN was an instrument for allocating resources, distributing revenues and resources, and stabilising the macro-economy. Now, however, none of those functions is operating effectively. In 2001 the State Budget ran a deficit of 54.3 trillion rupiah. Out of Rp286 trillion in total revenues and grants, Rp89.6 trillion went to interest payments and Rp54 trillion to petroleum subsidies, leaving only Rp45.5 for development expenditures. Moreover, the amount of State Budget expenditures going to local governments increased more than one hundred percent in 2001 as a result of Law No. 25/1999 which went into effect in January 2001. As part of a program to decentralise government authority, Law 25 shifted government revenues (as well as service delivery) to local regions according to specified formulas. In the APBN the so-called Balance Fund represents the central government revenues transferred to local governments and consists of designated portions of revenues from certain taxes, a general allocation fund, and a special allocation fund. In 2001 the Balance Fund amounted to Rp81.5 trillion, or 5.5 percent of GDP, compared to only Rp35.6 trillion of State Budget expenditures that went to local and regional governments in the 1999/2000 budget. At the same time, the privatisation program for state-owned enterprises did not reach the APBN target of Rp6.5 trillion for 2001. This failure was due more to political conflict of interest than to economic factors.

Most significantly, the rescue measures to re-capitalise distressed banks that the government "was compelled" to undertake in the 1997-98 crisis are imposing a heavy burden on the APBN. The government took over bank assets that had been financed by loans and in turn gave the banks specially issued government bonds. While the interest on these bonds generates income for banks, the interest payments are State Budget expenditures. Based on the original APBN, domestic interest payments amounted to Rp59.6 trillion, or 18 percent of total expenditures, in budget year 2001 compared to Rp15 trillion and Rp18 trillion respectively in 1998-99 and 1999-2000.[2] By comparison, budget expenditures for civil servants' salaries amounted to only Rp40 trillion in 2001. In other words, if the government did not have to make the interest payments on re-capitalisation bonds, it could have increased civil servants' salaries by more than 100 percent. Based on APBN, foreign interest expenditures in 2001 totalled Rp27.4 trillion, or 8.2 percent of total expenditures. The interest payments on government bonds and notes issued to finance the bank rescue will be a burden on the budget for many years to come.

Among other efforts, the government is trying to cover the fiscal deficit through the sale of assets managed by the National Banking Recovery Board (BPPN). The BPPN is the organisation managing the assets of distressed banks before reselling them. This effort is now considered a success. Before expenses, BPPN had cash deposits of Rp27 trillion and Rp10 trillion in bonds. BPPN's target for asset sales in 2002 is yet higher, Rp35.3 trillion, but even the targeted amount does not cover the expected APBN deficit of Rp43 trillion.

2. See *Financial Note and State Budget Plan* 1999/2000.

Foreign Loans

Indonesia cannot count on foreign loans to finance its future economic growth. On the contrary, its current foreign borrowing is a growing fiscal burden, with interest payments comprising 8 percent of total State Budget expenditures. As of 2001 Indonesia carries US$131.2 billion in foreign loans, of which US$71.4 billion represents government borrowing and US$59.8 billion is private debt (Table 4). The interest and principle repayment obligations on foreign loans reduce the amount of state savings that are available for the development budget and all other routine budget components. To meet the interest payments on its foreign loans the government has had to increase tax revenues, obtain new foreign loans, sell assets managed under BPPN, reduce subsidies, and sell state-owned enterprises (BUMN). To overcome the fiscal drag and enable it to start pushing domestic economic activity, the government approached creditor countries requesting debt rescheduling, haircuts, dispensations, and grants. So far, creditor countries have only agreed to delay for 20 years the repayment of principal that was due in 2000-03. But Indonesia must still pay the interest on these foreign loans every year. Thus, rescheduling is not a long-term solution, since the government needs to undertake new borrowing to repay old loans and interest.

Bank Loans

To reduce Indonesia's dependence on foreign borrowing the government earlier took steps to increase the role of domestic financial institutions, such as banks. During the 1980s it implemented various policies (June 1983 Package, October 1988 Package) to improve bank efficiency. Those policies helped banks mobilise domestic funds and increase the volume of bank loans. The mobilisation of savings through banks moved too rapidly, however, outpacing private sector demand for loans, even more so because of high interest rates.

The upheaval of the rupiah exchange rate and the decline in public confidence at the time of the 1997 economic crisis sent the banking industry into crisis. The weakening currency generated a liquidity problem for banks, which compounded the sector's internal problems, including weak management systems, excessive credit concentration, lack of transparency of financial information, and still ineffective supervision by Bank Indonesia. Bank lending fell in half from Rp545 trillion in 1998 to

Rp277 trillion in 1999 (Table 4).

The banking sector did not start to recover until the end of 1999 because of delays in restructuring and re-capitalisation, which depended on the success of the government bond issues. The bank re-capitalisation program was completed in 2000 and bank capital rose from negative territory in 1999 to reach Rp53.5 trillion in December 2000. Banks' capital adequacy ratio (CAR) increased, loan distribution and fund mobilisation improved, and net interest margin turned positive (BI *Annual Report* 2000). Nevertheless, banks did not resume their normal financial intermediary function because of continued risk and uncertainty and because the restructuring was not yet completed. Similarly in 2001, financial intermediation by banks failed to achieve the expected level because banks were focused on meeting the eight-percent CAR requirement and striving to lower their total non-performing loan ratios (NPLs) to five percent.

Capital Market

The capital market became an alternative source of relatively low-cost, long-term funding from the 1980s. However, even though the capital market can meet the requirements of the private sector, government, and state-owned enterprises, Indonesian entrepreneurs did not readily tap this source of funds. Before the crisis, bank financing dwarfed financing through the capital market. For example, in 1991 the value of bank loans was ten times the value of equity issues (Table 4).

Since July 1997, though, bank lending has been declining and capital market financing has become more important for the business sector. In 2001, the value of bond and share issues reached almost three-fourths the value of bank lending (Table 4). It is recognised that excessive dependence on bank borrowing by Indonesian businesses resulted in a "mismatch," with long-term investments being financed with short-term bank loans. Such a risky situation contributed to the protracted economic crisis. To reduce this mismatch, the role of the dominant supplier of funds for business should shift from the banking sector to the capital market.

CAPITAL MARKET DEVELOPMENT BEFORE AND AFTER THE ECONOMIC CRISIS

The existence of a capital market in Indonesia dates at least from 1912 when the Dutch Colonial government established a stock exchange. Since then, the government has issued various policies on the capital market. In particular it imposed a number of requirements on share trading. Eventually the capital market stagnated because of lack of investor interest and the stock exchange was closed in 1956. In addition, regulations were disadvantageous to entrepreneurs and the public lacked understanding of the capital market as a means of investment.

Development of the Capital Market before the Crisis

The real development of the capital market in Indonesia started in 1977 when the Jakarta Stock Exchange was re-opened under the newly created Capital Market Operation Board (BAPEPAM) of the Ministry of Finance. Corporate bonds began to play a role as capital market instruments in 1983. Jasa Marga (the state-owned highway construction and maintenance corporation) issued the first bonds, using the proceeds to finance construction of toll highways, among other things. Bond issues by Jasa Marga were followed by ones from Bank Bappindo, a state-owned bank, and Bank Papan Sejahte, a private bank. The bond market grew slowly at first. From 1983 to 1988 there were a total of only twenty-four issues, twelve by Jasa Marga, four each by Bappindo and Papan Sejahtera, and one issue each IBJ Leasing, Astra Internasional, UPPINDO, and BPD East Java, which are private enterprises. The total overall value of bonds issued in these first five years was only Rp855.72 billion.

During the 1980s, the government started to reform regulations that had obstructed investor interest in the Bourse in order to create a climate conducive to business. The Pakdes package of 1987 (effective 24 December 1987) relaxed government regulation of the market and licensing and had a major effect on the market's development. This package reduced the role of the government in the stock exchange, allowed share values to fluctuate according to market forces, introduced over-the-counter (OTC) trading, and allowed foreigners to purchase shares on the stock exchange. It also simplified certain procedures for issuing securities, including the application for sight draft share issues and the licensing of supporting institutions (securities brokers, securities traders, the securities administration bureau, trustees, and guarantors). The Pakdes package was expected to encourage firms to offer their shares on the stock market.

In December 1988, government undertook further deregulation focused on the capital market and non-bank financial institutions (NBFIs) with the Pakdes package of 1988. This package permitted privately owned stock exchanges, supplementing the existing government-operated exchange and paving the way for new exchanges to open in major cities outside Jakarta. It also expanded securities trading on JSE (Jakarta Stock Exchange) by allowing companies that had already listed shares to list all their remaining previously issued shares without further underwriting.

The Pakdes package adopted in December 1990 (effective 2 January 1991) reformed the institutional structure of the capital market. This package provided for conversion of the Capital Market Operations Board into the Capital Market Supervisory Agency (under the same acronym, BAPEPAM), privatisation of the JSE, and over-the-counter trading, and it changed the capitalisation requirements for securities companies including brokers, issuers and underwriters.

Indonesia's capital market made significant progress following these three deregulation packages of the late 1980s. The Surabaya Stock Exchange was established in 1989. From 1991 to 1997 the number of companies issuing shares rose from 145 to 306 and the value of equity issues outstanding went from just under Rp9 trillion to almost Rp71 trillion (Table 5). Foreign capital drove the market during the early 1990s, with 70 percent of transactions in 1994 involving foreign investors (Table 6). Foreign investors increased their presence through joint ventures with domestic brokers, but the number of domestic broker-dealers did not increase.

TABLE 5
Bond and Share Issues by Listed Companies, 1991-2001

	Number of Issuers		Number of Outstanding Issues		Value of Outstanding Issues Rp billion	
	Bonds	**Shares**	**Bonds**	**Shares**	**Bonds**	**Shares**
1991	24	145	384,032	1,178,465,725	2,215.2	8,976.1
1992	34	162	653,788	1,761,393,686	3,856.8	11,161.8
1993	43	181	725,047	3,338,513,735	5,761.8	16,065.0
1994	46	231	763,448	6,401,933,047	6,691.3	26,528.0
1995	50	248	788,264	11,110,964,641	8,694.4	35,395.0
1996	55	267	805,474	25,343,423,026	11,535.5	49,981.4
1997	70	306	848,077	51,459,413,729	18,740.5	70,879.6
1998	43	309	848,507	62,719,348,831	18,890.5	75,947.0
1999	46	321	857,590	714,460,834,556	23,174.4	206,686.8
2000	50	347	1,014,445	811,675,983,545	28,787.4	226,057.3
2001	55	379	1,067,695	826,770,663,455	31,662.4	231,342.1

Source: Indonesia Capital Market Supervisory Agency.

TABLE 6
Stock Market Transactions by Foreign and Domestic Investors, 1992-2001

	Foreign Investors		Domestic Investors		Total
	Rp billion	**%**	**Rp billion**	**%**	**Rp billion**
1992	1,237.8	59.08	857.5	41.02	2,095.2
1993	11,547.6	60.50	7,538.6	39.50	19,086.2
1994	17,881.1	70.17	7,601.7	29.83	25,482.8
1995	21,690.5	67.03	10,667.0	32.97	32,357.5
1996	45,693.6	60.34	30,036.3	39.66	75,729.9
1997	62,801.1	52.18	57,584.0	47.82	120,385.2
1998	41,556.6	41.69	58,128.1	58.31	99,684.7
1999	51,727.4	34.98	96,152.6	65.02	147,880.0
2000	24,684.0	20.11	98,090.7	79.89	122,774.8
2001	10,517.0	10.78	87,005.8	89.22	97,522.8

Note: Data refer to Jakarta Stock Exchange only.
Source: Indonesia Capital Market Supervisory Agency.

The bond market developed slowly during the 1980s because

- Most bond purchasers were pension fund institutions, which tended hold the bonds until maturity rather than resell them in the secondary market. This limited the liquidity on the bond market.
- Low liquidity in the secondary market made it difficult for holders to cash-in their bonds.
- High interest rates made time deposits more attractive than bonds as an investment alternative.
- With the takeoff of the stock market in 1989 investors were attracted to shares, hoping to gain high dividends.

In 1992 investors became more interested in bonds as the interest rate on time deposits began to decline and as the equity market had become bearish. From 1992 to 1997 the number of companies issuing bonds doubled, from 34 to 70, and the value of bond issues outstanding more than quadrupled, from Rp3.9 to Rp18.7 trillion (Table 5).

Enactment of Law No. 8 of 1995 was another milestone in the development of Indonesia's capital market. This legislation made full disclosure, self-regulation, and supervision the three fundamental principles of the capital market. With full disclosure, issuing companies and other parties involved in the capital market must do business with transparency, openness, and honesty. Self-regulation by the stock exchange, bourse, and other supporting institutions facilitates market supervision while government supervision ensures proper performance of the market. This law also permitted the sale of open-end mutual funds.

With the enactment of the 1995 Capital Market Law and other regulations, the capital market entered a stage of rapid development driven by strong investor interest. Investments in the capital and money markets increased significantly after 1995 (Table 7). Both internal and external factors contributed to a climate conducive to portfolio investment. Significant internal factors included Indonesia's diverse natural resources; domestic market potential; abundant, relatively low-cost labour; political, and economic stability; investment policies consistent with global economic development and free flow of foreign exchange; and strategic location. External factors attracting investment to Indonesia included decreasing communication costs, increasing competition, and rising business costs in the industrial countries.

TABLE 7
Real and Financial Sector Investment, 1991-2001

	Real Sector		Financial Sector	
	Domestic Investment Rp billion	**Foreign Direct Investment US $ million**	**Outstanding Share Issues Rp billion**	**Inter-bank Call Money Rp billion**
1991	41,078	8,778	8,976.1	48,420
1992	29,342	10,340	11,161.8	57,808
1993	39,450	8,143	16,065.0	90,107
1994	53,289	27,353	26,528.0	110,990
1995	69,853	39,945	35,395.0	189,259
1996	100,715	29,929	49,981.4	447,564
1997	119,873	33,827	70,879.6	784,368
1998	60,741	13,598	75,947.0	2,104,924
1999	53,168	10,892	206,686.8	595,362
2000	92,410	15,412	226,057.3	279,263
2001-1h	37,668	4,965	231,342.1	216,899

Note: FDI amount refers to approvals.
Source: Indonesia Capital Market Supervisory Agency and Central Bank of Indonesia.

Impact of the Crisis on the Capital Market

In barely a decade up to 1997, Indonesia made substantial progress in creating the complex set of laws and rules on which the capital market depends. The stock exchanges were privatised and computerised. The foundation was laid for scripless trading and book-entry settlement to become operational in 2000. Prudent rules for internal controls of custodians and broker-dealers were promulgated. But when the monetary crisis broke out in August 1997, the government was unable to continue to support the rupiah in the foreign exchange market. The resulting sharp devaluation of the rupiah against the U.S. dollar eventually affected the capital market, as most issuers had liabilities or loans in foreign currencies. In addition, Indonesia's rapid economic growth had been backed by foreign loans to a few large enterprises that were protected by government policies (including prohibition of new investors from entering certain business sectors). Moreover, “mark-up” practices on bank loans had paralysed the national banking system, which had a domino effect on the economy. The monetary crisis exposed economic malpractice. Many Indonesian banks and private companies had un-hedged foreign exchange liabilities, and within six months the devaluation caused many businesses to become insolvent.

The currency crisis generated a crisis of confidence among foreign as well as domestic investors, making them reluctant to invest directly in Indonesia because of the social, political, and security risks. The value of approved domestic and foreign investment plunged immediately after 1997 (Table 7). The sharp decline in investment in the real sector was partly due to the increased risk of national stability brought on by the riots that followed the change in government. Investment approvals increased during 2000 in response to the election of a new president and vice presidents by the People's Consultative Council (MPR), although approvals were below the levels in the years before the crisis. Investors remained cautious because Indonesia was included among the high investment-risk countries. This risk worsened with the declining political support for the government.

Financial investment also suffered as a result of the economic and currency crisis. The total value of stock market transactions fell from Rp120 trillion in 1997 to Rp99 trillion the next year. The share of transactions by foreign investors declined from 52 percent to 42 percent (Table 6). Continuing political instability and national security concerns dampened foreigners' interest and their share of transactions fell to just under eleven percent by 2001.

The succession of political developments and such fundamental factors as political conflict, the weakening of the rupiah, the need to meet with the IMF, the budget deficit, and other domestic problem hit the stock market. Share prices recovered after the General Meeting of the People's Consultative Assembly (MPR) in 2000 in response to the plan to reshuffle the cabinet, but they fell again with the formation of the new cabinet, which did not meet the expectations of market participants. Anxiety over national political developments, demonstrations, and the impending impeachment which drove down the prices of large company shares leading up to the 2001 Special Meeting of the MPR (Table 8). The government's discussions with the IMF were expected to resolve the immediate problem and to cover the 2001 fiscal deficit, which would improve the value of the rupiah against the U.S. dollar. The crisis apparently also affected the bond market. In the four years after 1997, there were 24 new bond issuers, but the value of issues outstanding increased by only Rp12.9 trillion (Table 5).

TABLE 8
Composite Share Price Index, 1991-2001

	Composite Share Price Index
1991	247.4
1992	274.3
1993	588.8
1994	469.6
1995	513.8
1996	637.4
1997	401.7
1998	398.1
1999	676.9
2000	416.3
2001	392.0

Source: Indonesia Capital Market Supervisory Agency.

In 2001 Indonesia's capital market faced continued uncertainty on a number of fronts. National political stability and security was one threat, in addition to the possibility of a soft or hard landing for the U.S. economy. Those uncertainties made investors modify their strategy and endeavour to decrease risk to a minimum level.

Improper financing techniques caused this crisis. Indonesia would have avoided economic collapse if corporations had used equity financing and long-term bonds and if foreign exchange liabilities had been hedged. The lesson is that a capital market is essential for economic stability. Equity and bond financing are the basis for stable growth. The crisis increased Indonesia's awareness of the importance of the capital market and its role in the economy. Concrete steps have been taken to improve disclosure in international loan syndication, especially with regard to risks of un-hedged or non-self-liquidating loans. In addition, fiscal and other incentives are being used to encourage corporations to raise funds by selling equities on the domestic market. The number of underwriters and investment management companies (especially domestic companies) increased from 1999-2000 (Table 9).

TABLE 9
Recent Development of the Securities Industry, 1999-2000

	Number of Companies	
	1999	**2000**
Broker–dealers	100	93
Foreign joint venture	5	4
Domestic	95	89
Underwriters	7	13
Foreign Joint venture	3	5
Domestic	4	8
Investment managers	65	70
Foreign Joint venture	27	27
Domestic	38	43

Source: Indonesia Capital Market Supervisory Agency.

Impact of Bank Re-capitalisation

The government's rescue of the banking sector by replacing banks' equity with specially issued bonds may create new problems for the capital market and the economy when these bonds begin to mature. The first re-capitalisation bonds were SU-001 bonds with a nominal value of Rp80 trillion to mature on 1 October 2017 issued on 28 September 1998 by the Reform Cabinet of President Habibie. By May 1999, the government had issued three more bonds: Rp53 trillion in 20-year bonds with an interest rate of 3 percent above inflation; Rp95 trillion worth of government bonds with 3- to 10-year maturities at a floating interest rate and yield related to 3-month SBIs; and Rp8.6 trillion with 5- or 10-year maturities at interest rates between 12 and 14 percent. In addition, the government also issued Rp103 trillion worth of bonds to re-capitalise PT Bank Mandiri (a state-owned bank). By 2001, bank-re-capitalisation obligations represented 65 percent of the value of government bonds outstanding (Table 10).

TABLE 10
Government Bonds Outstanding by Program, 1999-2002
(Rp trillion)

	Amount Outstanding as of 31 December			
	1999	**2000**	**2001**	**2002**
Guarantee program	218.31	218.31	218.31	218.31
Credit program	9.97	9.97	9.97	9.97
Bank re-capitalisation program	281.83	425.54	430.74	422.42
Total	510.11	653.82	659.02	680.70

Source: Ministry of Finance.

Many of these bonds will mature between 2004 and 2009. If the maturity structure is not re-balanced and there is no surplus in the primary budget, the government will have to conduct a large-scale refinancing (increase debt) to meet these repayment obligations. This could have a negative impact on the economy. Rising market interest rates may crowd the private sector out of the financial market and cutbacks in APBN expenditures for other development programs could suppress economic growth. Even with a surplus in the APBN primary balance (revenues minus non-interest related expenditures), if the maturity profile of government bonds is not re-structured, the fiscal pressure generated by the repayment of maturing bonds will cause economic turbulence during the period 2004 to 2009. For the government to refinance these bonds by issuing new bonds on the domestic market it would have to pay high interest. A vicious cycle will occur, with increasing total government debt pushing up the market rate of interest, and eventually causing deeper complications and pushing economic activity towards crisis.

CAPITAL MARKET PROSPECTS FOR FINANCING ECONOMIC DEVELOPMENT

Indonesia needs to work on many fronts to ensure adequate financing to restore the economy and return to sustained long-run growth. It needs to bring back the foreign investment that fled in the 1997 crisis and to build the domestic capital market into a significant source of long-term financing for domestic companies. With these steps and additional measures to stabilise the macro economy, the future prospects for the capital market are good.

Attract FDI

With a scarcity of funds from other sources, Indonesia needs to restore inflows of foreign direct investment (FDI), but this is becoming more difficult as competition among countries for FDI has intensified. Since the crisis, Indonesia has been liberalising investment policy, simplifying procedures, and intensifying promotional activities to attract foreign financing.

Measures to make licensing procedures for FDI projects faster, easier, and more transparent and to improve opportunities for investing in Indonesia include:

- Allowing the Minister of Investment/Chairman of Investment Co-ordinating Board (BKPM), rather than the president, approve FDI projects up to US$100 million. Indonesian ambassadors overseas should soon be given full authority to approve foreign investments.
- Transferring approval for domestic investments up to Rp10 billion to provincial government authorities.
- Delegating authority from the Minister of Investment/Chairman of Investment Co-ordinating Board (BKPM) to the Management Agency of the Integrated Economic Development Area (KAPET) to accept and evaluate applications for foreign investments in the KAPET.
- Eliminating principal approvals that were normally issued by governors.
- Eliminating, for all but four sectors, the requirement for investment applications to be recommended by technical/sectoral departments before approval by the Minister of Investment/Chairman of Investment Co-ordinating Board. The recommendation requirement may also be eliminated for the four remaining sectors (mining, energy, palm oil plantations, and fisheries).
- Requiring investment approvals to be processed within 10 to 20 working days. “Same day service” is being planned.
- Encouraging the growth of small-scale businesses.
- Enacting an Anti-Monopoly and Unfair Business Practices Law.
- Allowing FDI companies to enter retail and wholesale/distribution trade business and establish holding companies in Indonesia.

In addition to these steps to improve the business climate, steps to improve the political environment are essential to restoring investors' confidence about doing business in Indonesia.

Encourage Domestic Investment through the Capital Market

The reforms of the 1980s spurred the development of the capital market, but participation by domestic investors did not grow along with other measures of market progress. Foreign investors still dominated stock exchange transactions up to 1997 (Table 6). Indonesia's population constitutes a potentially large customer base and comparative advantage for the capital market that should be exploited, but previous efforts to encourage Indonesians to participate in the capital market have not been fruitful.

Now, Indonesia needs a breakthrough to encourage domestic investment through the capital market. Increased participation by investors in outlying regions through regional securities companies and long-distance trading would lead to wider distribution of share ownership among domestic investors. To this end, domestic businesses need to offer positive incentives for investors through good business practices and competitive profit levels and they need to establish more extensive networks. Furthermore, the capital market infrastructure should be updated and enhanced with sophisticated, secure systems. At the same time, the market must develop the operational and marketing capability required to serve large-scale domestic capitalists.

Improve the Functioning and Scale of the Capital Market

According to the World Bank, in the era of investment liberalisation, investment through bank loans has declined while portfolio investment and FDI have increased. This trend in global financial markets presents Indonesia with the opportunity to increase the efficiency of its capital market. It also raises the question of whether that capital market is capable to take over banks strategic role as a source of funds. In fact, the capital market demonstrated its reliability as a financial institution even in the crisis. Although the value of stock market transactions decreased from 1997 to 1998 and again in 2000, the volume of transactions has increased every year except 2000 (Table 11). The capital market's role as a source of funds for the business sector and as an investment alternative for the public became even more important as a result of the IMF agreement, which stressed increased supervision of the banking sector, but did not constrain efforts to utilise the national stock exchange.

TABLE 11
Transaction Volume and Value on the Jakarta Stock Exchange, 1991-2001

	Number of shares transacted		Value of shares transacted	
	million shares	% change	Rp billion	% change
1993	3,844.0	252.84	19,086.2	810.94
1994	5,292.5	37.68	25,482.8	33.51
1995	10,646.4	101.16	32,357.5	26.98
1996	29,527.7	177.35	75,729.9	134.04
1997	76,599.1	159.41	120,385.2	58.97
1998	90,620.5	18.30	99,684.7	-17.20
1999	178,486.6	92.55	147,880.0	48.35
2000	134,531.3	-22.90	122,774.8	-16.98
2001	148,381.3	10.29	97,522.8	-20.57

Source: Indonesia Capital Market Supervisory Agency.

Indonesia needs to exert continuous effort to enhance the capacity of the capital market to generate long-term funding through a variety of alternatives including obligations as well as stocks or equities—and also to increase the government's funding options. Furthermore, since Indonesia is far behind its neighbours in utilising the capital market, it should also focus on increasing the volume of transactions in the market. This requires altering the behaviour patterns of entrepreneurs as well as of the government. If a wider variety of capital market instruments becomes available, direct investment should begin to become a more important means of financing for Indonesian firms. Requiring companies to form pension funds that not only hold time deposits and other bank investments but also purchase stocks and other obligations would increase competition in the capital market and reduce the possibility of capital flight to international capital markets.

To reduce the risk of capital market transactions, investors must be adequately protected through appropriate regulation by the stock exchange as well as the government supervisory agency and other means. The recent increase in capital and money market transactions indicates that Indonesian businesses view favourably the support of the political circle and the armed forces under the present government.

Future Prospects and Problems for the Capital Market

A number of current indicators suggest that the prospects for the future development of the capital market are good. These include:

- The declining role of banking institutions as a source of funds since the 1997 economic crisis (Table 7). One lesson from the economic crisis of 1997 was the need to make greater use of the capital market to prevent a recurrence of the mismatch by which long-term investment was financed by a short-term bank funding.

- The privatisation of BUMN (state-owned enterprises) and the growing number of BUMN shares available in the capital market. Since most BUMN are in strategic, upstream industries they are quite attractive, and the entrance of PT Telkom, PT Indosat, PT Tambang Timah, PT Semen Gresik, PT Aneka Tambang, and PT Bank BNI has stimulated local investor interest in the capital market.
- The presence of international brokers and investment managers. Foreign investors have been participating actively in Indonesia's capital market for a long time and they have been encouraged by the change in the political climate, the determination to eliminate KKN (corruption, collusion, and nepotism), and the commitment to enforce the law. Improvements in economic and security conditions are expected to attract foreign investors back to the Indonesian market.
- The potential for high earnings growth. Indonesia's stock market offers attractive opportunities to foreign investors because of the decline in the exchange rate of the rupiah against the dollar and the correction in the prices of leading stocks.
- The many medium- and small-scale enterprises with listing potential. So far, companies participating in the capital market have been mainly large, strong capitalists, whereas most of Indonesia's medium- and small-scale entrepreneurs are also eligible to participate.
- The potential for broader domestic participation. In 1998 only around five-hundred thousand individuals or institutions participated in the capital market compared to Indonesia's total population of 200 million people (Ary Suta 2000).
- The growth of professionalism. The improved quality of the manpower in the capital market has increased investor enthusiasm.
- The good prospects of the capital market should be used to promote Indonesia as an attractive destination for foreign investment.

Against these optimistic conditions, there stand a number of factors that constrain the development of the national stock exchange. These include:

- Its relatively small capitalisation compared to competitors.
- The unfamiliarity and reluctance on the part of institutional investors whose participation is strategic.
- The uneven distribution of stock ownership in the domestic market.
- The illiquidity of stocks.
- The extensive and unchecked collusion and unprofessional behaviour among market participants.
- The need to carry out privatisation of the BUMN slowly, so as not to destroy them.
- The close connections between ownership and management, as well as cross-ownership between companies.

CONCLUSION

The capital market is important not only to finance growth but also to provide economic stability. Since the financial crisis of 1997, the collapse of Indonesia's banking sector and the fall off in government expenditures and foreign loans have turned the focus on the capital market as a source of long-term financing. Based on several indicators, Indonesia's capital market appears to have good prospects and a good opportunity to develop efficiently. This is especially true since capital market utilisation is still well below an optimal level.

For the capital market to serve the future needs of Indonesia's economy, share ownership must be more widely distributed, companies must offer investors a positive stimulus in the form of competitive profit rates and expanded business networks, and the market infrastructure must develop by adopting more sophisticated systems and improving operational and marketing capability. Those steps will make the domestic market more competitive and reduce the possibility of capital flight to international capital markets. In order for the domestic capital market to be a stable source of funds for Indonesian business, the average level of risk needs to be reduced. If investors have greater confidence in the capital market, they will be inclined not only to invest more but also to hold their investments for longer periods. The government should encourage capital market development by instituting a regulatory system to control issuance and a strong supervisory system to monitor day-to-day activities, all with the objective of good corporate governance and transparency.

In addition to these efforts to improve the capital market, Indonesia must solve several other problems that challenge the capital market. It must achieve macro-economic stability, assurance of the rule of law, harmonisation of rules and policies, improvement of securities industry infrastructure, and good corporate governance. It is possible that the climate in Indonesia will once again be conducive to investment and that Indonesia's capital market will take a competitive position in the global market.

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APPENDIX

DEVELOPMENTS IN CAPITAL MARKET REGULATION SINCE THE FINANCIAL CRISIS

Activities of Bapepam (Capital Market Supervisory Agency) in 1998

Issued new rules:

- Rule V.D.4, Control and Protection of Securities Deposited with a Securities Company
- Rule V.D.5, Maintenance and Reporting of Net Adjusted Working Capital
- Rule V.D.7, Main Points of Subordinate Loan Agreement
- Rule IX.D.4, Capital Increases without Pre-emptive Rights
- Rule X.K.5, Disclosure of Information by Issuers or Public Companies Regarding Bankruptcy
- Rule XI.B.2, Repurchases of Shares that Have Been Issued by an Issuer or Public Company
- Rule XI.C.1, Insider Securities Transactions that are Not Prohibited

Activities of Bapepam in 1999

Revised rules:

- Rule III.A.3. regarding Commissioners and Directors of Stock Exchanges, intended to encourage professional, effective and efficient management of the stock exchanges. The rule specifies the method for recruiting and selecting commissioners and directors, nominating procedures for candidates, and duties of directors.
- Rule V.D.4. regarding Control and Protection of Securities Kept by Securities Companies, relates to the obligations of securities companies in accounting for segregation of clients' securities in custody.
- Rule V.D.5, regarding Maintenance and Reporting of Net Adjusted Working Capital. Rule V.D. 5 main revised to form V.D. 5-3 and V.D. 5-4 and postponed implementation until April 2000.

Issued new rules:

- Rule XIV.B.1, regarding Procedures for Collecting Administrative Fines specified procedures for imposing fines for violation of capital market regulations and to improve collection of fines, requiring that fines be paid within 30 days.
- Rule V.D.7, regarding Guidelines for Subordinated Loan Agreement of Securities Companies established standards for subordinated loans that are applicable in the assessment of net adjusted working capital of securities companies.

Activities of Bapepam in 2000

Revised existing regulations:

- Rule VIII.G, regarding Guidelines for the Preparation of Financial Statements, revising decision No.Kep-97/PM/1996, 28 May 1996
- Rule IX.A.2, Registration Procedures for a Public Offering, revising decision No. Kep-43/PM/1996, 17 January 1996
- Rule IX.A.7, Responsibilities of Underwriters with Respect to Subscriptions and Allotments of Securities in a Public Offering, revising decision No. Kep-48/PM/1996, 17 January 1996
- Rule IX.A.8, Preliminary Prospectus and Information Memorandum, revising decision No. Kep-113/PM/1996, 24 December 1996
- Rule IX.C.1, Form and Content of a Registration Statement for a Public Offering, revising decision No. Kep-113/PM/1996, 24 December 1996
- Rule IX.C.3, Guidelines concerning the Form and Content of a Prospectus for a Public Offering, revising decision No. Kep-51/PM/1996, 17 January 1996

Appendix: Activities of Bapepam in 2000 (continued)

- Rule IX.D.1, Pre-emptive Rights, revising decision No. Kep-41/PM/1998, August 14, 1998
- Rule IX.D.2, Guidelines Concerning the Form and Content of a Registration Statement for Issuing Pre-emptive Rights, revising decision No. Kep-42/PM/1998, 14 August 1998
- Rule IX.D.3, Guidelines Concerning the Form and Content of a Prospectus for Issuing Pre-emptive Rights, revising decision No. Kep-43/PM/1998, 14 August 1998
- Rule IX.E.1, Conflict of Interest on Certain Transactions (to accelerate the restructuring of the company), revising decision No. Kep-12/PM/1997, 30 April 1997
- Rule IX.E.2, Material Transactions and Changes of Main Business Activity, revising Letter No. S-456/PM/1991
- Rule IX.F.1, Tender Offers, revising decision No. Kep-85/PM/1998, 24 January 1998

Issued new rules:

- Rule III.B.6. Guarantee of Securities Transaction Settlement
- Rule III.B.7. Guarantee-Fund
- Rule V.D.8. Activities of Securities Company on several location
- Rule V.D.9. Guidelines Concerning Contract of Securities Company Agent as Member of Securities Exchange
- Rule IX.H.1. Take Over the Public Company

Prepared a draft amendment to Capital Market Law No. 8, 1995. In addition to providing for de-mutualisation of the stock exchange and issuing of shares without par value this amendment made Bapepam an independent state institution free from government intervention.

Activities of Bapepam in 2001

Publicised the draft amendment to the Capital Market Law designed to harmonise Indonesian law with international capital market practices and standards, to respond to fundamental shifts in the global financial services industry, and to accommodate the interests of market participants.

Initiated discussions with the Directorate General of Financial Institutions, the Ministry of Finance, and the Bank of Indonesia regarding integrating the supervision of the financial services industry under one agency.

Revised:

- Rule No.III.A.3, concerning Commissioners and Directors of Stock Exchange. The revision aimed to improve the integrity and quality of stock exchange management to prepare the exchange to confront global competition. The revised rule also intended to push stock exchange management to encourage capital market participants to implement management practices in accordance with good corporate governance principles.
- Rule No.IX.A.6, concerning Restrictions on Shares Issued Prior to an Initial Public Offering
- Rule No.IX.E.2, concerning Material Transactions and Change of Main Business Activity
- Rule No.IX.D.1, concerning Pre-emptive Rights, increased investment alternatives by allowing corporations to issue warrants for up to 30 percent of paid-in-capital.

Represented Bapepam in 2 separate court cases

Imposed sanctions on 28 securities companies, 2 securities company representatives, 8 securities administration agencies, 1 custodian bank, and 130 issuers

Appeared as expert witness for the National Police in 5 court cases and for the Attorney's Office in 3 cases.