CHAPTER 3

2007 - 2009 FINANCIAL CRISIS TOWARD INDONESIAN FINANCIAL SECTORS

3.1 Government's Financial Account

Financial contagion may have occurred swiftly as investors' appetite for emerging market diminished. Indonesia, which began to rely for development financing on debt securities and private sector financing after the 1997-1998 crisis, is now vulnerable to external shocks that result in disruption of foreign capital flows. Most foreign investments are short term and it is very easy to change course. While foreign direct investment (FDI) (considered more permanent) has increased since 2005, portfolio investment still takes up a great portion of foreign investment flows to the country.

Table 3.1 Foreign Investment Balance

in IDR bio	Mar 2007	Jun 2007	Sep 2007	Dec 2007	Mar 2008	Jun 2008	Sep 2008	Dec 2008
Current account	2640	2271	2151	3430	2794	-1022	-943	-223
A. Goods, net (trade balance)	7712	8107	7487	9448	7536	5443	5772	4558
1. Exports, fob	26,626	29,202	30,009	32,177	34,412	37,345	38,081	29,452
2. Imports, fob	-18,914	-21,095	-22,521	-22,729	-26,876	-31,902	-32,309	-24,894
B. Services, net	-3163	-2991	-2764	-2922	-2992	-3374	-3316	-3331
C. Income, net	-3163	-4024	-3811	-4527	-3123	-4460	-4823	-2929
D. Current transfers, net	1254	1178	1240	1432	1373	1369	1423	1478
Capital and financial account	1836	2029	-935	660	-1395	2524	918	-3752
A. Capital account	43	127	255	122	52	73	200	29
B. Financial account	1793	1902	-1190	539	-1447	2451	718	-3781
1. Direct investment	-246	1426	764	309	-270	605	405	1739
A. Abroad, net	-1282	392	-1427	-2358	-1730	-1436	-1517	-1179
B. In Indonesia (FDI), net	1037	1034	2191	2667	1460	2041	1922	2918
2. Portfolio investment, net	2491	3810	465	-1200	1984	4188	-74	-4345
A. Assets, net	-497	-1897	-1257	-764	-823	60	-65	-434
B. Liabilities, net	2988	5707	1722	-437	2807	4128	-9	-3910
3. Other investment	-452	-3334	-2419	1430	-3160	-2342	387	-1176
A. Assets, net	-105	-2283	-2360	262	-2672	-1974	-1610	-3844
B. Liabilities, net	-348	-1051	-59	1168	-489	-367	1998	2669
Total	4476	4300	1217	4091	1400	1502	-25	-3976
Net errors and omissions	-97	-663	-37	-570	-367	-177	-63	-236
Overall balance	4379	3637	1179	3520	1032	1324	-89	-4212

Source: Bank Indonesia

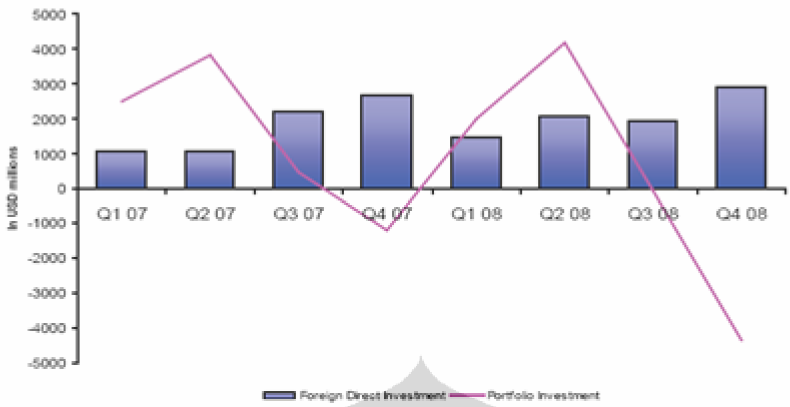

Figure 3.1 FDI and portfolio investment 2007 and 2008

Source: Bank Indonesia

According to the latest data from Bank Indonesia, FDI was still increasing in the quarter to December 2008, whereas portfolio investment had continued its declining trend since the previous quarter.

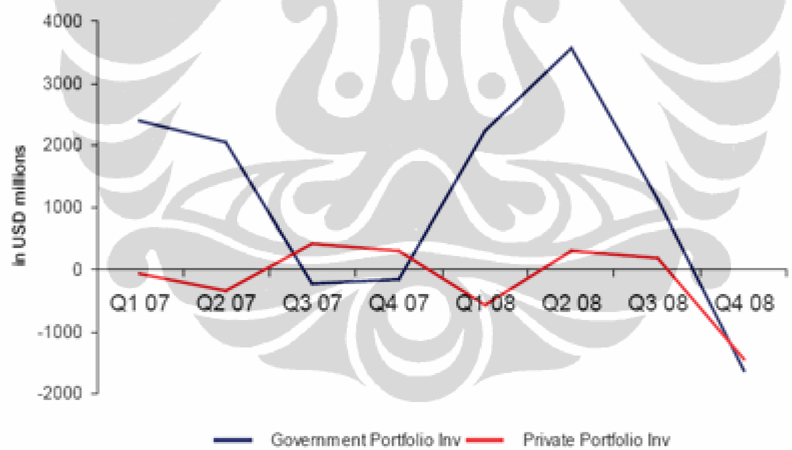

Figure 3.2 Portfolio investment by government and private sector 2007 and 2008

Source: Bank Indonesia

Figure 3.2 shows that most foreign capital flow went to government securities, reaching a peak in the second quarter of 2008. During the last three months of 2008, a massive sell-off of government bonds and Bank Indonesia certificates by foreign investors put the capital and financial account of the balance of payments in deficit. In addition, there was a significant increase in currency and deposit placements by private sectors abroad.

Looking in more detail at the government financial account, we see that foreign holdings of government securities reversed course abruptly in mid-September 2008 when the Lehman Brothers bankruptcy was announced. This trend appeared to stabilize in November 2008.

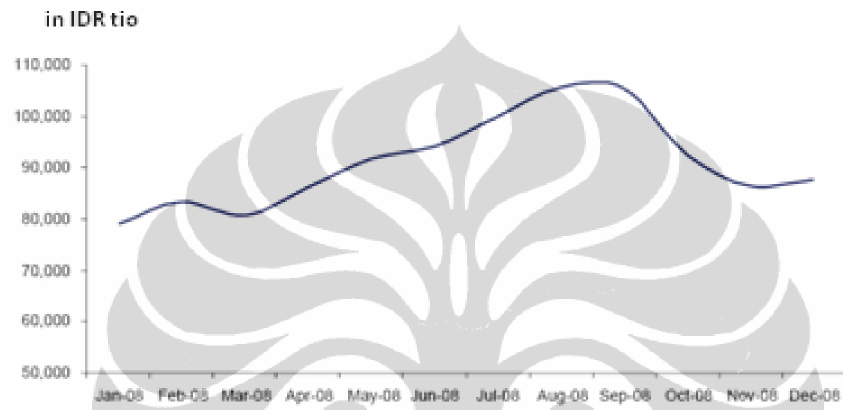

Figure 3.3 Foreign ownership of government securities 2008 (in IDR trillion)

Source: DMO

Prices of government securities have dropped owing to suddenly unfavorable emerging markets conditions – as pure financial contagion occurred when negative market sentiment and changed perception of risks set in. At the same time, the rupiah was already under depreciation pressure, and this produced a second blow for government bond prices. With these price drops, investors demanded higher yields. The yield spread (Indonesia's global bonds and US Treasury notes) was increased from 411 basis points at the end of September 2008 to 716 at the end of the year (January data still recorded an increase to 754). At the end of October 2008, the 10-year tenor government bonds had even reached their highest peak of 20.96%. The government was forced to postpone the issuance of a new series of government bonds indefinitely (Ministry of Finance, 2008).

SUNs (government securities) yields declined towards the end of the year when the central bank cut the benchmark interest rate in early December. With inflationary pressure eased further, foreign holdings of SUNs at the end of the year increased slightly. Nevertheless, during the last three months of 2008, foreign holdings of SUNs dropped from US$11.1 billion to $8 billion.

Foreign ownership of SBIs (Bank Indonesia certificates) is always more volatile than is the case for government securities. A huge drop of SBI foreign holdings occurred in October 2008, recorded at IDR6082 trillion, after being IDR20,366 trillion in the previous month. For the period October-December 2008, foreign holdings of SBI certificates fell drastically, from US$2.2 billion to $772 million.

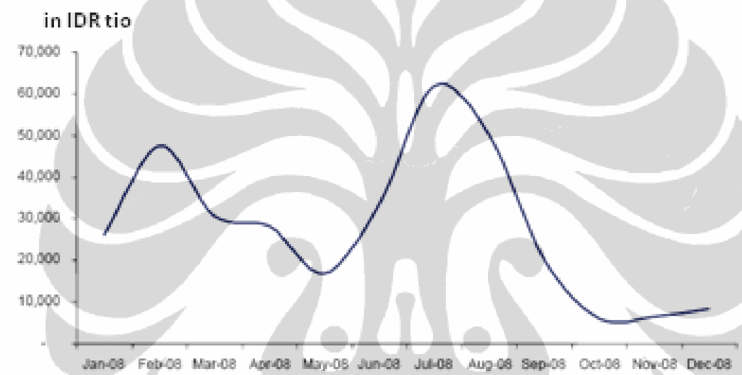

Figure 3.4 Foreign ownership of SBIs 2008 (in IDR trillion)

Source: Bank Indonesia

The latest data on the private sector financial account showed that only FDI recorded a significant increase of almost 10% (year-on-year). Private portfolio investment and private other investment recorded deficits. On the liabilities side of private portfolio investment, a deficit of US$1 billion was recorded as equity transactions in the stock exchange plummeted, particularly in October 2008.

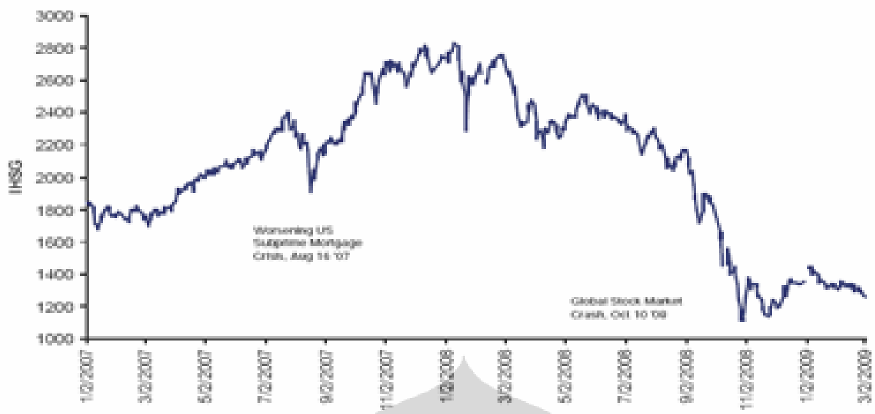

Figure 3.5 Indonesian Stock Exchange index 2007 and 2009

Source: CEIC Asian Database

3.2 Equity and Capital Market

For the full year 2008, the stock exchange index fell 51.17%, with 26.04% in the last three months of the year. Market capitalization for equity at the end of the year fell by 46.42%. The top 10 companies with the biggest market capitalization on the stock exchange for 2008 are dominated by banking (Bank Mandiri, BCA), mining (Bumi Resources, Adaro Energy, PGN), plantation (Astra Agro Lestari) and telecommunication (Telkom, Indosat) companies. Only the last was considered as having a better outlook, owing to its domestic orientation. Banking, mining and plantation are predicted to be severely affected by the global crisis. Figure 10 shows volatile net equity foreign purchase during 2008.

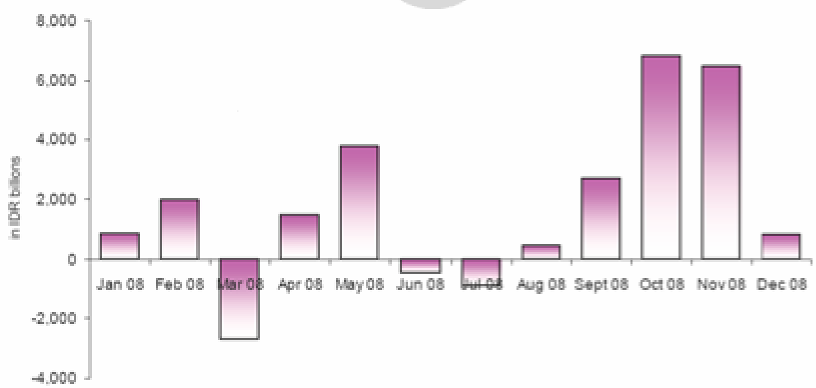

Figure 3.6 Net equity foreign purchase 2008

Source: Indonesian Stock Exchange

Based on data from the Indonesian Central Securities Depository, up to 24 December 2008, foreign ownership of equity on the Indonesian Stock Exchange was IDR436.3 trillion (67% of total equity market capitalization), whereas local investors owned the remaining 33%, or 210.23 trillion. Compared with 2007, composition was relatively similar, with foreign ownership reaching 66% in December 2008.

In the corporate bond market, local investors were far more dominant, with 96% (of total corporate bond capitalization/IDR67.74 trillion) of ownership. Foreign investors controlled around 4% (2.71 trillion). During 2008, corporate bond issuance occurred only in the first half of the year, worth approximately 11.9 trillion. This value was an extreme decline (61.94%) from total corporate bonds issuance in 2007, worth 31.27 trillion. There were three cases of corporate defaults in 2008, and many companies postponed their bond issuance plan, such PT PLN (the state electricity company) and Bank Danamon, Tbk. At least two factors were pointed out as the reasons why bond issuance by private sector dropped sharply in 2008: i) the high domestic inflation rate up to September 2008; and ii) the looming uncertainties from the global crisis, reflected in the declining appetite of investors in capital markets, especially in emerging markets.

On the private ‘other investment’ items, a deficit of US$1.7 billion was recorded at end-2008. On the liability side, a surplus of $2.1 billion was recorded – relatively unchanged compared with the surplus recorded in the previous quarter. The surplus owed to an increase of private sector external loan drawings of the Indonesian corporate sector, from $3.3 billion to $3.6 billion, while the Indonesian banking sector drew $0.5 billion of external loans. The increase in loan drawings was larger than the increase in private sector loan repayment – it rose from $2 billion in the previous quarter to $2.4 billion. At the end of 2008, the outstanding loan of Indonesian banks and corporations was recorded at $62.6 billion, consisting of $9.6 billion loan to banks and $53 billion to non-bank institutions. On the asset side, there was a huge increase of other investments by Indonesian residents in foreign countries – indicated by an increase of overseas accounts belonging to Indonesian banks. Net other investments of the private sector financial account had a $1.7 billion deficit at the end of 2008 – much worse than the surplus of $500 million recorded three months before.

The possibility of adverse impacts may come also as a majority of foreign creditors of Indonesian banks and corporations are from Singapore (31.6% of Indonesian private sector outstanding external loans), the Netherlands (19.6%), Japan (13.6%) and the US (6.5%). Another possibility of disruption in foreign capital flows will come from the fact that most creditors do not have any ownership ties to the Indonesian side. Per September 2008, approximately 30.8% of outstanding private external short-term loans came from holding companies and/or affiliated businesses – the amount to mature in 2009 will be US$22.6 billion. It is argued that ownership ties to creditors will keep flows of external loans moving. Rollover and refinancing risks are more likely to occur to debtors without ownership ties to creditors.

Table 3.2 Creditors status, September 2008

Creditors	% Outstandings
Holding Companies	19.6
Afiliated Companies	11.2
International Institutions	0.6
Others	68.6
Total	100

Source: Bank Indonesia

3.3 Exchange Rates

The rupiah had been under deep depreciation pressures and fluctuated greatly even after measures were put in action. In a year, the rupiah lost 16.9% of its value and up to 2 March 2009 it had already depreciated almost 10% from its value at the beginning of the year. Central banks' foreign exchange reserves had depleted by around US$7 billion in September-October owing to market interventions to prevent rupiah depreciation. Bank Indonesia appears to have abandoned market interventions since November 2008 and allowed the currency to be relatively free-floating.

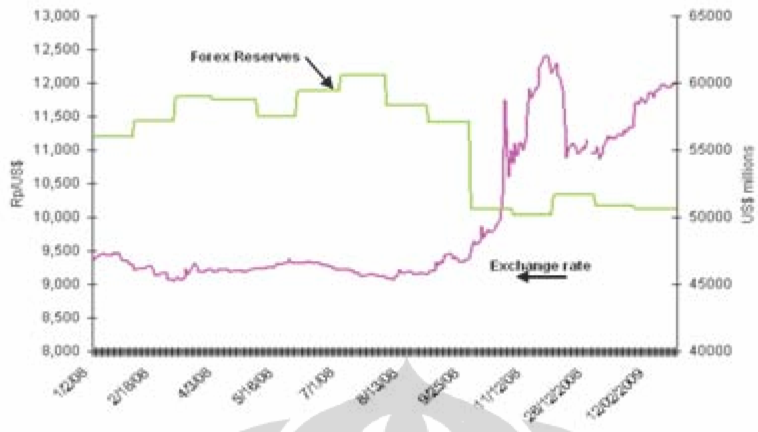

Figure 3.7 IDR exchange rate and foreign reserves 2008-2009

Source: CEIC Asian Database

In February 2009, the rupiah was still under pressure, with a currency default swap still widening, from 539 to 643. According to data from Bank Indonesia and the Ministry of finance, total government external debt to be paid in 2009 will reach IDR73.28 trillion, while repayment of domestic debt will reach IDR38.91 trillion. Total government debt payable this year is IDR112.19 trillion, the highest since 1998-1999. From the private sector, corporate bonds that will meet their due in the first semester of 2009 will achieve IDR8.8 trillion (for the whole of 2009, repayment will reach IDR13 trillion). Information on short-term external debts that needs to be paid in 2009 may be behind investors' jitters to hold a long position on the rupiah. In addition, the volume of foreign exchange reserves is perceived to be very thin owing to a significant drop in export revenues starting in October 2008. Figure 3.8 shows that nominal effective exchange rates dropped significantly in November 2008.

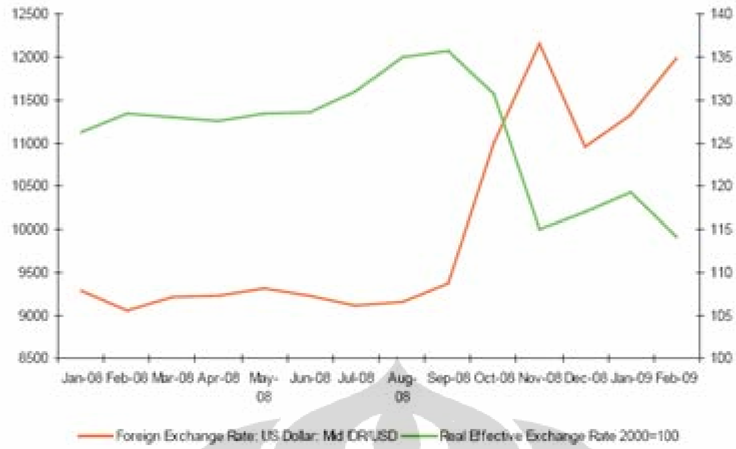

Figure 3.8 Nominal and real effective exchange rate (2000=100) 2008-2009

Source: Bank Indonesia and www.bis.org

3.4 Banking Industry

During the Asian crisis of 1997-1998, prudential regulation was finally legally enforced in the banking system, so in the wake of the current crisis there is no grave threat of a collapse of the banking system. In the latest report in 2008 by the central bank, no financial institutions are identified as having direct exposure to any related sub-prime mortgage securities. There are at least two reasons as to why this is the case. First, none of Indonesia's banks has presence abroad, including in developed countries. This in itself limits their exposure to sub-prime mortgage-related securities, which are traded mainly there. Second, banks are not allowed to undertake investment activities such as purchasing securities and/or securities-based products (investment activities) or issuing and selling securities in capital markets. It should be noted that Indonesia does not have any investment banks. Bank Indonesia noted that the banking sector in Indonesia in 2009 consists of commercial banks (124) and regional/local credit banks (1897).

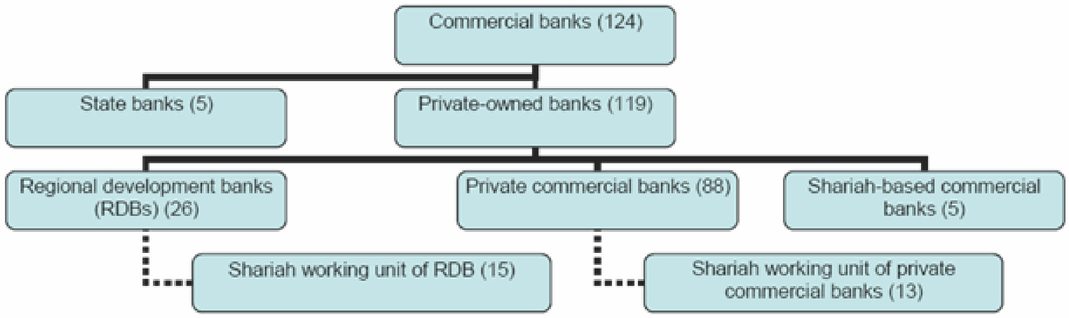

Figure 3.9 Commercial banking systems 2008

Source: Bank Indonesia

Regional/local credit banks are divided into 1769 conventional credit banks and 128 shariah-based banks. These banks have limited capital and are not part of the monetary authority payment system. The 2008 available data on commercial banks show that, of the top 10 list of banks with the biggest assets up to March 2008, there are three state banks. The rest are mostly joint venture (JV) banks – the majority from neighboring countries in the region such as Singapore, Malaysia and New Zealand. Only one foreign bank, Citibank, made it onto the top 10 list.

Table 3.3 Ownership structure of top 10 banks with biggest assets

		Type of bank	Assets (IDR trillions)	Foreign ownership (%)	Foreign owner(s)
1	Bank Mandiri	State	282,710	0.00	-
2	Bank Central Asia	JV	213,957	51.15	Farindo, Mauritius
3	Bank Rakyat Indonesia	State	200,075	0.00	-
4	Bank Negara Indonesia	State	162,344	0.00	-
5	Bank Danamon Indonesia	JV	89,800	68.83	Temasek, Singapore
6	Pan Indonesia Bank	JV	55,137	35.00	ANZ, New Zealand
7	Bank Niaga*	JV	54,846	60.38	CIMB Group, Malaysia
8	Bank International Indonesia	JV	50,550	55.85	MayBank, Malaysia
9	Citibank	Foreign	43,558	100.00	US
10	Bank Permata	JV	41,224	44.50	Standard Chartered, UK

Note*: Bank Niaga merged with LippoBank under SPPin 2008

Source: Bank Indonesia

Consumption credit expansion started to slow down from 34.21% (year-on-year) in September to 33.5% in October 2008. In November 2008 it grew even slower, by 31.9% (year-on-year). December 2008 and January 2009 saw even slower consumption credit growth, 29.9% and 28.8%, respectively. However, as Figure 3.10 demonstrates, while consumption credits had already slowed down, investment credits still grew. It was suspected that, owing to a drying-up of liquidity on the overseas financial market, domestic importers sought to find credits from domestic banking sectors during this period. Nevertheless, since October 2008, investment credits have also subsided.

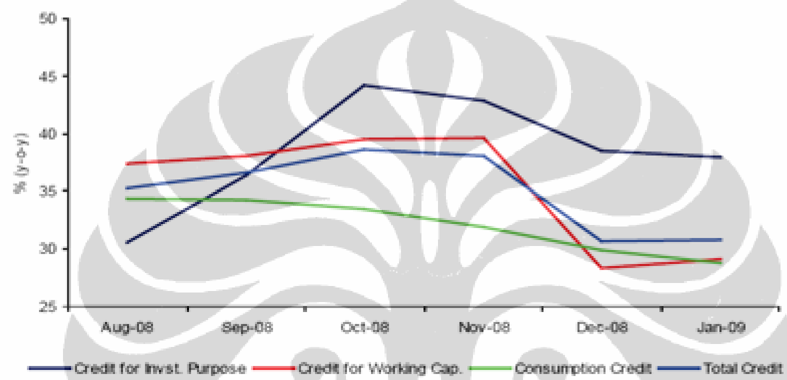

Figure 3.10 Banking credit growth by type of use from Aug 2008-Jan 2009

Source: Bank Indonesia

When adjusted to the prevailing exchange rate, overall banking credit disbursement has actually slowed down. Growths of credit disbursement in rupiah became slower (year-on-year) – 37.1%, 36.7% and 30.5%, respectively, in October, November and December 2008 (figure 3.4). Outstanding credit in foreign exchange also grew more slowly, by 19.7% in October 2008 – slower than the 28.6% growth in September 2008. As signs of weakening domestic demand were spotted early this year, there were great concerns regarding the Indonesian banking sector. It should be noted that, besides consumers, corporations from non-tradable sectors of the economy (such as trade, restaurants and hotels and other business service sectors) also have big shares in banks loans. Domestic purchasing power is a key factor in the bank business.

Throughout 2008, credit growth was persistently higher than growth of third-party funds in the banking sector. This certainly added to the liquidity squeeze faced by the commercial banks after September 2008. Commercial banks apparently financed their credit growth by selling some of their SUN holdings, because the SUN price continued to fall as a result of diminishing foreign investor appetite for emerging markets, reflected in the decline of banks' secondary reserves. But towards the end of the year, when signs of economic slowdown became very visible, commercial banks' holdings of SUNs were once again on the rise. The latest data show that commercial banks' holdings of SUNs increased from December 2008, from IDR258.75 trillion to IDR271.99 trillion in March 2009.

A similar trend is visible in commercial banks' holdings of SBIs. After being criticized for their preference in placing large holdings of low-risk and liquid SBIs rather than channeling funds to the real sector, the practice was slowly abandoned; since 2007-2008, commercial banks have kept their funds in a healthy proportion of SBI holdings and credit disbursements. However, SBI bank holdings recorded a steep rise from October 2008, increasing from IDR87.7 trillion (September 2008) to IDR124.42 trillion in October. Further, November and December 2008 also saw a rapid increase, to IDR152.3 trillion and IDR166.5 trillion. With great uncertainty nowadays, banks appear to be taking safety and precautionary actions, rather than attempting to make a profit by disbursing credits to the crisis-vulnerable business sector.

A depreciated value of the rupiah would increase banks' risks. However, with banks' net open position (NOP) at 6.2% (of their capital) up to December 2008, the banking sector seemed to cope with this, even if the rupiah is depreciated further by IDR5000.

The sale of SUNs by foreign investors could also adversely affect banks – particularly as the Indonesian banking sector is the largest holder of tradable SUNs (IDR265 trillion as of 30 November 2008). The government took some action to buy back SUNs in the market in order to stop prices from sliding downward during 2008. Until the end of Semester 1 2008, SUN prices were down 15%. The Indonesian banking sector lost approximately 1.4 trillion as a result of marked-to-market of banks' holdings of tradable SUNs (6.6% of total SUN holding in the banking sector).

The remaining SUNs held by banks are held-to-maturity kinds. Compared with banks' revenues, reaching up to IDR220 trillion, this loss would seem trivial.