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AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D. C. 20523

PROJECT PAPER

INDONESIA: Financial Markets
(497-0360)

August 30, 1988

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PROJECT DATA SHEET

1. TRANSACTION CODE: A (A = Add, C = Change, D = Delete) — Amendment Number: ______

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2. COUNTRY/ENTITY: Indonesia

3. PROJECT NUMBER: 497-0360

4. BUREAU/OFFICE: Asia/Near East — 04

5. PROJECT TITLE (maximum 40 characters): Financial Markets

6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM DD YY — 09 30 94

7. ESTIMATED DATE OF OBLIGATION (Under 'B.' below, enter 1, 2, 3, or 4)
A. Initial FY 88 B. Quarter 4 C. Final FY 92

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 88 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total	4,147	3,000	7,147	9,000	–	9,000
(Grant)	(4,147)	(3,000)	(7,147)	(9,000)	( )	(9,000)
(Loan)	( )	( )	( )	(–)	(–)	(–)
Other U.S. 1.						
Other U.S. 2.						
Host Country	–	–	–	–	3,000	3,000
Other Donor(s)	–	–	–	–	–	–
TOTALS	4,147	3,000	7,147	9,000	3,000	12,000

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	C. 2. Loan	D. OBLIGATIONS TO DATE 1. Grant	D. 2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	E. 2. Loan	F. LIFE OF PROJECT 1. Grant	F. 2. Loan
(1) SDA	710	840	–			9,000		9,000	
(2)									
(3)									
(4)									
TOTALS						9,000		9,000	

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each): 819 831 867

11. SECONDARY PURPOSE CODE

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code	BU						
B. Amount							

13. PROJECT PURPOSE (maximum 480 characters)

To increase the number of debt and equity securities and commodity contracts available to investors, and to increase the trading volume of these instruments.

14. SCHEDULED EVALUATIONS
Interim MM YY 09 90, MM YY 09 92 Final MM YY 09 94

15. SOURCE/ORIGIN OF GOODS AND SERVICES
[X] 000 [ ] 941 [X] Local [ ] Other (Specify) ______

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ____ page PP Amendment.)

I have reviewed the methods of implementation and financing in this Project Paper.

C.W. Christensen
Curtis Christensen
Controller

17. APPROVED BY
Signature: David N. Merrill
David N. Merrill
Title: Mission Director
Date Signed: MM DD YY 08 30 88

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION
MM DD YY

AID 1330-4 (8-79)

PROJECT AUTHORIZATION

INDONESIA

FINANCIAL MARKETS PROJECT
PROJECT NO. 497-0360

1. Pursuant to Section 106 of the Foreign Assistance Act of 1961, as amended, and in accordance with the authority delegated to me under Delegation of Authority No. 652, I hereby authorize the Financial Markets Project for the Republic of Indonesia (Cooperating Country) involving planned obligations of not to exceed $9,000,000 in grant funds over a six year period from date of authorization, subject to the availability of funds in accordance with the A.I.D. OYB/allowance process, to help in financing foreign exchange and local currency costs for the Project. The planned life of the Project is six years from the date of initial obligation.

2. The Project consists of institutional strengthening and policy implementation assistance directed at improving the investment, trading and regulatory environment for financial markets in Indonesia, particularly the capital market. A.I.D. financed inputs will include technical assistance, training and commodities.

3. The Project Agreement, which may be negotiated and executed by the officials to whom such authority is delegated in accordance with A.I.D. regulations and Delegations of Authority, shall be subject to the following essential terms and covenants and major conditions, together with such other terms and conditions as A.I.D. may deem appropriate.

   a. <u>Source and Origin of Commodities, Nationality of Services.</u>

      (1) Commodities financed by A.I.D. under the Project shall have their source and origin in the Cooperating Country or in the United States, except as A.I.D. may otherwise agree in writing. Except for ocean shipping, the suppliers of commodities or services shall have the Cooperating Country or the United States as their place of nationality, except as A.I.D. may otherwise agree in writing. Ocean shipping financed by A.I.D. under the Project shall, except as A.I.D may otherwise agree in writing, be financed only on flag vessels of the United States.

      (2) Notwithstanding paragraph 3.a.(1) above, suppliers of training services required under the Project from third countries may have their nationality in countries neighboring or within the same region as Indonesia and in countries included in A.I.D. Geographic Code 901.

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b. Conditions Precedent

Prior to the disbursement of any funds under the Grant for the financing of long-term technical assistance for the Ministry of Finance (MOF) or Bank Indonesia (BI), or to the issuance of any commitment documents with respect thereto, the Cooperating Country will, except as A.I.D. may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D., evidence that MOF and BI have appointed the necessary counterparts to work on a full time and exclusive basis with the consultants to be provided under the Project. This condition may be satisfied separately by MOF and BI with respect to the long-term technical assistance each is to receive under the Project.

c. Covenants

(1) The Cooperating Country agrees to develop a yearly detailed implementation and training plan for the Project which will describe the sequence of activities to be undertaken and persons to be trained in each fiscal year. Unless otherwise agreed by A.I.D., the implementation and training plan for each year will be submitted to A.I.D. for review and approval prior to the start of the year covered by the plan.

(2) The Cooperating Country will supply sufficient funds to maintain and supply equipment furnished under the Project.

David N. Merrill
Director

8/30/88
Date

Drafted:jmcarroll:jmc:08/24/88:doc.5201P:pages 15-16

PSD:GWest ______ Date 8/24/88
PPS:GLewis ______ Date 8/24/88
FIN:CChristensen ______ Date 8/30/88
LA:PScott ______ Date 8/30/88
A/DD:EVoulgaropoulos ______ Date 8/30/88

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ANNEXES

GLOSSARY

Indonesian Term	Abbreviation	Translation
	ADB	Asian Development Bank
	ADEF	Asian Development Equity Fund of the ADB
	ARSSP	Agricultural and Rural Sector Support Program
P.T. Bahana Pembinaan Usaha Indonesia	BAHANA	A GOI-owned Venture Capital Company with limited investments.
Bank Pembangunan Indonesia	BAPINDO	National Development Bank. Provides "soft" loans to eligible development projects.
Badan Pelaksanaan Pasar Modal	BAPEPAM	Capital Market Executive Board. Public agency responsible for supervising the operation of Indonesia's capital market institutions.
Badan Koordinasi Penanaman Modal	BKPM	Investment Coordinating Board. Public agency charged with supervising private investments, domestic and foreign.
Badan Perencanaan Pembangunan Nasional	BAPPENAS	National Development Planning Agency.
Badan Usaha Milik Negara	BUMN	State-Owned Commercial Enterprise.
Bank Indonesia	BI	Bank Indonesia. The GOI central bank, with responsibilities similar to the U.S. Federal Reserve System.
Bank Pembangunan Daerah	BPD	Regional Development Bank
Bursa Paralel		Indonesia's over-the-counter market

	CDSS	Country Development Stragety Statement, USAID/Jakarta
P.T. Danareksa	DANAREKSA	National Unit Trust. A mutual fund corporation established and owned by the GOI to assist the Indonesianization of companies by purchasing shares and issuing mutual fund certificates.
	ESOP	Employee Stock Ownership Plan
Ficorinvest		A non-bank financial institution owned by Bank Indonesia
	GOI	Government of Indonesia
	ICE	The Indonesian Commodities Exchange
	IFC	International Finance Corporation, IBRD
	IGGI	Inter-governmental Group on Indonesia
	IIF	Institute of International Finance
Ikatan Wanita Pengusaha Indonesia	IWAPI	Indonesian Business-womens' Association
Departemen Keuangan	MOF	Ministry of Finance
	NBFI	Non-bank financial institution
	OTC	Over-the-counter (market)
P.T. Jasa Marga		The GOI toll road authority
P.T. Papan Sejahtera		A middle-income housing finance institution

Penanaman Modal Asing	PMA	Official designation for foreign private investments with a maximum foreign equity share of 95 percent.
Penanaman Modal Dalam Negeri	PMDN	Official designation for domestic private investments with a maximum foreign equity share of 49 percent.
Perserikatan Perdagangan Uang & Efek - Efek	PPUE	Association for Money & Securities Traders. Organization recently given the responsibility of organizing an over-the-counter securities market.
Pengembangan Usaha Swasta	PSD	Office of Private Sector Development, USAID/Jakarta
Rencana Pembangunan Lima Tahun	REPELITA	National Five Year Development Plan.
Sertifikat Bank Indonesia	SBI	Bank Indonesia (Central Bank) Certificates. A discount instrument, issued in various denominations and with maturities of 15, 30 and 90 days.
Surat Berharga Pasar Uang	SBPU	Money market certificates comprised of promissory notes and trade bills issued in various denominations and with maturities not exceeding 180 days.
	SOE	State-owned enterprise
	UPPINDO	A non-bank financial institution with development objectives.

DEFINITION OF FINANCIAL TERMS

Assets	Resources that have the potential for providing future benefits or other resources of a firm or which can be converted into cash and used to pay liabilities. Assets are equal to total liabilities plus net worth.
Bill	A security that represents short-term discount debt, usually issued by the government.
Bond	A security that represents long-term debt.
BOT	Build-operate-transfer. The process whereby a contractor agrees to build a facility, operate it for a period of time, then transfer ownership to another party, often, but not always, the government.
Broker/dealer	A firm that both buys and sells securities as an agent for customers (broker) and also buys and sells securities for its own account and risk (dealer).
Capital	Money or property. Also used to refer to net worth.
Capitalization	The total of a company's long-term debt and net worth.
Capital market	The sector of the financial markets for long-term securities.
Clearinghouse	An adjunct to a commodity exchange through which transactions executed on the floor of the exchange are settled.
Collateral	Assets that are given as security for a loan.
Commodity market	The sector of the financial markets for trading contracts representing goods, such as rubber and coffee.
Contract	See futures.
Debt service	The total of the payments of principal and interest on debt during any one period.
Debt service ratio	Total debt service during one period divided by earnings before interest and tax payments for that same period.
Discount	To price a security at less than par value.

Dividend	A payment by a company to its stockholders.
Equity	The capital raised by a company through the sale of stock.
Face value	See par value.
Financial markets	The combination of the capital market, money market and commodity market.
Fixed investment	Investment in assets which are fixed, such as plant and equipment.
Floating-rate bond	A bond whose interest payment varies with the short-term interest rate.
FOB	Free-on-board. The cost of placing commodities on board whatever shipment conveyance is being used.
Futures	Standardized contracts, wherein only the price and date of delivery must be specified, which cover the sale of commodities for delivery in the future. Futures contracts are usually satisfied by the sale or purchase of a separate contract which cancels the first contract and not by actual delivery of the commodity.
Go public	the act of selling equity, i.e., transferring full or partial ownership, to the public for the first time.
Hedging	A means of risk protection against extensive loss due to adverse price fluctuations. Usually accomplished by buying one security or good and selling another security or good in such a way as to result in a riskless position.
Interbank market	The process by which banks trade short-term securities among themselves in order to adjust their liquidity.
Intermediation	Investment through a financial institution.
Leverage	Use of debt to increase the expected return on equity. Leverage is measured by the ratio of long-term debt to long-term debt plus equity. Also called financial leverage or gearing.
Liabilities	Total value of financial claims on a company's assets. Equal to total assets minus net worth.

Liquidity	The resilience of the price of a security to buying and selling pressures. A market is liquid when there is a large enough number of traders to make entering and exiting the market easy. For banks, liquidity is also used to refer to the amount of cash on hand.
Liquidity ratio	Short-term assests divided by short-term liabilities.
Long-term	A security with a maturity of greater than five years.
Market maker	A securities firm that buys and sells securities for its own account and risk at specified prices.
Medium-term	A security with a maturity of from one to five years.
Money market	the sector of the financial markets for short-term securities.
Net present value	A project's net contribution to wealth, equal to the discounted value of future cash flows minus the initial investment.
Net worth	The value of a company's assets minus its liabilities.
Note	A security that represents debt, usually with a maturity less than 15 years. Often used to refer to such debt issued by the government.
OTC market	Over-the-counter market. A securities market which lacks a formal trading arena, such as a stock exchange. The trading occurs via telephone, computer or other types of contacts among brokers and dealers who generally maintain a supply of securities "in stock" to meet customer demands. The Bursa Paralel in Indonesia is designed to be an OTC market.
Paid-in capital	The amount contributed to a firm by stockholders in exchange for their shares of stock.
Par value	The value of a security shown on the security certificates itself. Also called the face value.
Perfection	Establishing a legal right to a debtor's assets.
Physicals	Nonstandardized contracts, wherein all aspects of the transaction such as quantity, quality, price, date of delivery and place of delivery must be specified, which cover the sale of commodities for either current delivery or delivery in the future. Physicals contracts are usually satisfied by actual delivery of the commodity

Premium	To price a security at more than par value.
Primary market	The initial distribution of securities by the underwriter.
Prime rate	The interest rate charged by banks to their biggest and most creditworthy customers. Other interest rates are scaled up from the prime rate.
Private placement	The private sale of securities, usually to a small number of investors and without advertising to the public.
Promissory note	A promise to pay.
Return on equity	Earnings before interest and tax payments divided by total equity.
Secondary market	Trading in a security after the initial distribution of the securities by the underwriter.
Security	A legal document which provides evidence of ownership or creditorship.
Semi-concessional	A level which is less than the current market price. Usually used to refer to interest rates that are lower than prevailing market interest rates. Also referred to as soft interest rates.
Serial bonds	A package of bonds that mature in successive years.
Short-term	A security with a maturity of less than one year.
Soft	See semi-concessional.
Stock	A security that represents ownership interest in a company.
Time deposit	An interest bearing deposit of funds with a bank for a certain period of time, like a savings account or a certificate of deposit (CD).
Underwriting	Buying an issue of securities from a company and reselling it to investors.

1. SUMMARY

The Financial Markets Project is a six year, $12.0 million effort whose goal is to increase the availability of long-term investment capital by supporting open financial markets. This will be accomplished by increasing the number of debt and equity securities and commodity contracts available to investors, and by increasing the trading volume of these instruments. USAID's contribution will be $9.0 million in development assistance grant funds (Section 106, SDA). The GOI will contribute $3.0 million (equivalent) in cash and in kind. This project follows on the substantial prior experience of USAID and the Ministry of Finance (the executing agency) in working together on capital market development, and is viewed as a critical step in the Government of Indonesia's (GOI) deregulation process to promote non-oil exports.

Given the GOI's desire to proceed with the deregulation of selected state-owned enterprises, the capital market can also play a major role in assisting such deregulation through public offerings of shares. Establishing a deregulation fund to facilitate such public offerings may be the subject of a future amendment to this project.

2. BACKGROUND ON FINANCIAL MARKETS

2.1 THE ROLE OF FINANCIAL MARKETS

2.1.1 The Importance of Investment and Savings

Increased investment in capital assets is crucial for Indonesia's continued economic development, both to increase the per capita productivity of its current industries and to develop non-oil industries on which the country's economy will increasingly depend. However, due primarily to the drop in oil prices, the overall level of investment in Indonesia has been declining. Annual fixed investment dropped from 24% of GDP ($20 billion) in the early 1980s to an estimated 20% ($16.5 billion) in 1987.[1] The largest investment decline occurred in the public sector, primarily in large-scale projects to develop non-oil industries. Private investment, which was low initially (only slightly exceeding public investment levels), also declined "due to the direct impact of the deteriorating terms of trade on private incomes and savings, as well as the reverse multiplier effects of a slowdown in aggregate demand."[2] On a positive note, in 1987 both foreign and domestic fixed investment increased above the level in 1986.

If public and private investment do not expand significantly, Indonesia will not realize the sustained economic growth necessary to employ its large and growing population and to develop further. Although increasing the efficiency of invested capital or better utilizing excess production capacity will be helpful and necessary, sustained growth will require that annual fixed

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1 Indonesia Adjustment, Growth and Sustainable Development, 2 May 1988, World Bank, p. 27.

2 Ibid., p. 27.

investment not decline over the next two years and rise to approximately 23% of GDP ($19 billion) by the mid-1990s.[3] Much of this increase will have to come from the private sector. Its annual share of total investment should increase from 54% of GDP currently to 63% by the end of the century,[4] representing additional investments of approximately $52 billion.

In order to mobilize the investment necessary for sustained growth, Indonesia will have to do two things. First, because its savings are insufficient to finance this investment on its own, Indonesia will have to rely heavily on foreign investments and borrowings. Its $38.4 billion of foreign debt and 30% debt service ratio indicate that Indonesia is doing so. Fortunately, 78% of Indonesia's foreign debt carries soft or semi-concessional terms. Furthermore, any appreciation of the dollar relative to the yen (the currency in which much of Indonesia's debt is denominated) would result in a decrease in its debt service ratio.

Second, Indonesia will have to stimulate domestic savings. The annual national savings rate must increase from its current 19% of GDP to an estimated 25% by the mid-1990s in order to achieve the aforementioned level of investment.[5] (At the height of the oil boom in the early 1980s, Indonesia had a 25% savings rate but it was not sustained once oil prices declined.) Public sector savings can be increased through raising taxes, reducing or eliminating price subsidies, and increasing the operating efficiency of governmental agencies. Increasing private sector savings will require continued deregulation of business activities. The most important step Indonesia can take to increase both sectors' savings and investment, though, is to further develop its financial markets.

2.1.2 Benefits of Financial Markets Development

The term financial markets usually refers to the money market, which provides short-term financing, and the capital market, which provides long-term financing and includes the stock and bond markets. We have also included within financial markets the commodities market, which refers to the market where commodities contracts for goods (e.g., rubber and coffee) are traded for both present and future delivery. Annex E provides further definition of these markets for the interested reader.

The following discussion of the benefits of financial markets centers largely on the capital market because it is this market that will play the greatest role in increasing the availability of long-term investment capital in Indonesia. However, the project will also be working with the money and commodities markets, especially to the extent those markets will influence the way in which the long-term capital market functions.

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[3] Ibid., p. 27.
[4] Ibid., p. 30.
[5] Ibid., p. 27.

2.1.2.1 The Primary Benefit of Developing Well Regulated, Efficient and Active Financial Markets will Be to Encourage the Investment and Savings Necessary for Sustained Economic Growth

Investment will be encouraged because potential users of funds will be able to choose the financing alternative that provides the term, cost and conditions they require. Increasing the variety of available financing options will allow users of funds to match their assets (investments) and liabilities (borrowings). For example, virtually all debt financing in Indonesia has a maturity of one year or less. Borrowers usually roll over short-term loans to provide funds for long-term investments, which results in a dangerous mismatch between assets and liabilities. Each time the loan is rolled over a new interest rate is established, exposing the borrower to the risk that the investment will become unprofitable due to the increased interest expense. The increased availability of medium- and long-term debt finance resulting from efficient financial markets will help borrowers overcome these problems.

Savings will be encouraged because potential savers will be able to select the financial alternative that offers the liquidity, risk, return, and term they desire. Increasing the variety of savings alternatives is especially important for financial institutions such as pension funds and insurance companies. Because they lack both financing alternatives in and experience with the capital market, these institutions largely keep their assets in short-term time deposits, but their liabilities (future payments and claims) are medium- to long-term. Such a mismatch dramatically increases the potential for defaults and/or bankruptcies. Increasing the available savings alternatives will allow them to match their assets and liabilities and will reduce the likelihood of future problems. Furthermore, as they become more comfortable with the financial markets, their confidence will increase, thereby stimulating additional savings.

2.1.2.2 Financial Markets Development will Increase the Availability of Equity Capital

The presence of strong capital markets and a greater reliance on equity financing are essential to growth in the manufacturing and processing of agricultural and industrial goods, and the growth in employment required by Indonesia in the coming decades. Indonesia's tradition of financing industrial development through a heavy dependence on short- and medium-term loans is financially untenable. Lasting development requires a strong base of equity capital to ensure that an economic downturn does not bankrupt thousands of businesses. By encouraging investment and savings and increasing the types of securities available, the development of the financial markets will increase the level of equity finance relative to debt finance.

By increasing the availability of equity finance, development of the financial markets will also stimulate the development of small and/or new businesses. Experience in the U.S. and England has shown that small businesses provide more jobs, are more innovative and pay more in taxes per amount invested than big businesses. Small and/or new businesses require access to finance, especially equity finance. They need equity in order to endure a start-up period and to finance capital investment during the early years when internally generated cash usually is not sufficient.

2.1.2.3 As Financial Markets Develop and Investment and Savings Increase, the Flow of Funds from Investors to Users of Funds Will Become More Efficient

Increased efficiency will take place through a variety of mechanisms. First, the cost of intermediation will decrease because of increased competition to attract users and providers of funds. Second, the cost of raising funds will decrease because multiple small savings accounts will be aggregated into large pools of investment funds. Third, funds will increasingly be allocated to users based on credit risk, cash flow and profitability, and less on personal relationships and collateral. As a result, funds will flow to the most efficient firms and individuals. Per capita productivity, income and savings will increase.

Increased savings and investment has the further benefit of attracting foreign investors to provide both debt and equity capital. This inflow of foreign funds will help integrate Indonesia's domestic financial markets with the international financial markets, further increasing efficiency. The difference in cost of funds between these markets will narrow and the risks associated with interest and exchange rate fluctuations will be spread among a larger number of market participants.

2.1.2.4 Financial Markets Development Will Lead to Increased Economic Stability

First, an efficient capital market can contribute to the solvency of Indonesia's financial system. The virtual absence of equity and long-term debt finance weakens the financial structure of corporations. They are forced to finance primarily with short-term debt, thus increasing their leverage and exposure to interest rate risk. This endangers not only their long-term viability but also the solvency of their creditors in the banking system. As a result, investment is restrained and increases in productivity, incomes, and savings are limited. Where firms have access to a developed capital market, they tend to use both debt and equity instruments to finance their growth, with a resultant improvement in the solvency of the financial system.

Second, the development of financial markets will better enable the government to monitor the economy and implement fiscal and monetary policy. Financial markets development will improve accounting standards and the quality of financial reporting. Public transactions in securities will assist in identifying the flow of investment and savings in the economy. (Currently, it is extremely difficult to monitor these flows because many occur privately). Increasing the public disclosure of financial information and the public transaction of securities will also assist the government in assessing and collecting taxes.

2.1.2.5 Commodities Producers and Consumers Will Benefit by Reducing Their Exposure to Adverse Price and Exchange Rate Fluctuations through the Development of Futures Trading on the Indonesian Commodities Exchange (ICE)

This will increase the integrity and creditworthiness of the ICE because gains and losses are taken or paid as they occur in futures trading, not just when a contract matures, thus decreasing the potential for default in the face of large price changes. Because futures trading will establish a credible system of price setting for the commodities involved, this will also promote increased investment in the production of basic commodities.

2.1.2.6 Financial Markets are the Best Mechanism for Deregulating the Public Sector

Selling equity in state-owned enterprises (SOEs) to the public through the capital market will have several benefits for Indonesia's economy. First, it will improve public finances during the current period of declining government revenues. The government will reduce the need to use its limited resources to subsidize the operating costs of deregulated SOEs. Second, increasing the role of the private sector in public sector dominated areas of the economy will improve the country's overall economic performance. Third, by speeding up the rate of growth of the economy, deregulation will raise the level of employment.

Implementing deregulation through the public sale of securities in the financial markets avoids the problems associated with deregulating via public auctions or private placements. These latter mechanisms tend to be inadequate for large-scale deregulation because only wealthy firms, individuals or foreigners have sufficient capital to participate in public auctions or private placements. With deregulation, the resources available to the financial markets will be sufficient to handle large, complex transactions. Further, the public sale of securities in the financial markets is the most effective method for achieving widespread distribution of ownership.

Employee stock ownership plans (ESOPs) or similar plans to transfer ownership to employees can also be implemented most effectively through developed financial markets. If employees were given or sold ownership in a company which was not publicly traded, their investment would be extremely illiquid. No market, or only a very limited one, would exist through which they could sell all or part of their securities. By using the financial markets to effect an ESOP, employees will easily be able to liquidate their investment in the secondary market.

Conversely, the deregulation of SOEs is crucial to the development of the financial markets. Deregulation will supply both debt and equity securities to the financial markets. This will help alleviate the current problem of a lack of securities, which in turn hampers further financial market development. Deregulation will also help convince the private sector of the government's commitment to developing financial markets and help increase the efficiency of the markets. These factors, in turn, will help focus private sector attention on the financial markets. As private businesses begin to recognize the advantage of publicly selling debt and equity securities, they also will issue new securities. The increase in the supply and types of securities will cause investor interest and confidence in the financial markets to increase. Development of the financial markets and deregulation of the public sector are, therefore, mutually supportive and should be designed and implemented in unison.

2.2 INDONESIA'S FINANCIAL MARKETS

2.2.1 History of the Markets

The public trading of securities in Indonesia was started in Jakarta in 1912 by an association of Dutch stockbrokers. Two similar associations were established in other cities in Java in 1925. Most of the trading involved securities issued by Dutch companies or Dutch East Indies government agencies. The three associations continued active trading until 1942 when they were closed due to the outbreak of World War II.

In 1952, a securities exchange was reestablished in Jakarta, operated by the Association of Money and Securities Traders (PPUE) with Bank Indonesia playing an advisory role. At the time, PPUE's membership consisted of three Dutch private banks, two Dutch brokers and two Indonesian national banks. Trading was inactive and primarily involved bonds issued by the Industrial Bank of Indonesia (now called The Development Bank of Indonesia or BAPINDO) and stocks in several Dutch companies. After the nationalization of Dutch businesses in 1958 and a subsequent ban on the trading of Dutch company securities, the exchange ceased trading.

The high inflation of the 1960s ensured continued inactivity and precipitated substantial capital flight. To reduce capital flight, in 1968 the Government of Indonesia (GOI) passed a law excluding from tax the interest on time deposits at banks. This law has come to be a major obstacle to the development of Indonesia's capital market.

During the early 1970s Indonesia was earning substantial income from taxes on oil production. Bank Indonesia channeled much of this income to the five government banks which lent the funds at below market interest rates to predetermined priority sectors of the economy. Bank Indonesia also kept bank deposit and loan rates at very low levels, such that the real cost of funds was frequently negative. Since finance was plentiful, the GOI was not concerned about developing a capital market.

In 1973 the GOI authorized the establishment of merchant banks, which was seen by some as a step toward the eventual reestablishment of the capital market. Nonetheless, the stock exchange remained dormant until a series of capital market decrees were issued by the Ministry of Finance (MOF) in 1977. These decrees, which formed the foundation of the country's current stock exchange, established three capital market institutions — the Capital Market Policy Council, the Capital Market Executive Agency (BAPEPAM) and P.T. Danareksa — and instituted tax incentives for companies to go public.

The Capital Market Policy Council is comprised of several ministers and other top GOI officials and was created to provide capital market policy guidance to the MOF. BAPEPAM was established to institute, regulate and operate the stock exchange, to evaluate companies seeking a listing and to monitor the progress of listed companies. The Chairman of BAPEPAM is appointed by the President of Indonesia and is directly responsible to the Minister of Finance. Danareksa, the state investment company, was established to promote the equitable distribution of ownership of listed shares through underwriting securities and issuing mutual fund certificates in small denominations available to the public.

The tax incentives included a reduction in the tax rate for firms that went public, the extent of which was related to the amount of equity sold. Companies that went public also benefited by being allowed to revalue the assets on their balance sheet. Because investors were not taxed fully on their investment in shares, they also benefited.

For the first several years after the implementation of these decrees, the stock exchange grew, with several new listings appearing each year. Then the price of oil plummeted, tax revenues declined rapidly and the GOI decided that the private sector should be responsible for providing much of its own finance. The GOI also realized, however, that Bank Indonesia's interest rate regulations were inhibiting the flow of funds from investors to companies. In 1984, therefore, the GOI removed the controls on interest rates, maintained the tax-exempt status of time deposits and removed the tax incentives for going public. Immediately 6 to 12 month deposit rates rose to 18-20% and prime lending rates to 22-24%, where they remain today. The level of bank deposits and loans increased substantially. Due to both this focus on banks and the removal of tax incentives, the capital market declined to a state of virtual inactivity throughout the mid-1980s.

During this time Bank Indonesia introduced two new securities, SBIs and SBPUs, to the money market. SBIs are short-term (one to three month) Bank Indonesia bills. Bank Indonesia used SBIs as an open market instrument to control the liquidity of the banking sector. SBPUs are rediscounted bank paper with a maturity of up to 180 days and a minimum denomination of $15,000. Banks can sell their SBPUs to other banks (although usually they are sold to Bank Indonesia) when they need to increase their liquidity. Conversely, banks can purchase SBIs or SBPUs when they have excess liquidity. Neither SBIs nor SBPUs are traded on the stock exchange or by the public in general.

In 1987, as part of a broad deregulation plan, the GOI announced a series of decrees to stimulate the capital market. The decrees created a new over-the-counter market (Bursa Paralel) and liberalized the existing listing, underwriting and trading rules.

The over-the-counter market and stock exchange differ in several ways. In the former, an issuer of securities must have paid-up capital of Rp. 100 million and can be a new company. An issuer on the stock exchange must have paid-up capital of Rp. 200 million and have been profitable for the last two years. Banks that wish to go public on either market must have been financially sound for the last two years and have met Bank Indonesia's capital requirements for the last year. The over-the-counter market is operated by PPUE subject to the regulatory oversight of BAPEPAM. The stock exchange is both operated and regulated by BAPEPAM.

For both markets, issuers must be Indonesian companies and must provide financial statements that are compiled according to generally accepted accounting principles in Indonesia, audited by an independent public accountant, and accompanied by an unconditional/unqualified opinion for the last reporting period. For the over-the-counter market, an issuer must submit financial statements covering the period of its operation or two years, whichever is less. For the stock exchange, financial statements covering the last two years are required.

Underwriters on the over-the-counter market are required to make a market (stand ready to buy and/or sell a specified amount of shares or bonds at prices posted publicly by that particular market maker) in securities for which they are the lead underwriter for two years, although there is no similar requirement for the stock exchange. Other underwriters and qualified financial institutions may make a market in the securities of their choice. For an issuer to obtain and maintain its listing on the over-the-counter market, its securities must have at least two market makers.

2.2.2 Current Status of the Financial Markets

Stocks. Indonesia's stock exchange currently lists 24 companies with a total capitalization of approximately $100 million. Eighteen of these companies are foreign joint ventures, three originally were Dutch companies now listed as Indonesian firms, and only three are truly domestic Indonesian companies. There have been no new issues of equity since 1984 when the aforementioned tax incentives were removed.

Few if any of the listed companies have gone public because they needed equity finance. Instead, they did so to take advantage of existing tax incentives. Additionally, foreign joint ventures went public to comply with laws requiring the gradual transfer of ownership to Indonesians and to obtain rupiah finance because they were prevented from borrowing rupiah locally. There also are indications that some companies listed in order to obtain the government licenses necessary for expansion.

A positive development is that two listed companies are selling additional shares this year. There also are indications that one or two new companies will sell shares publicly before the end of 1988, although probably on the over-the-counter market. (At present, there are no listings of shares or bonds on this market, as it still is being designed and organized by PPUE.) This increase in activity is a good indication of the increased interest in the capital market resulting from the December, 1987 reform package.

Bonds. Bond issues have occurred every year since 1983. Through 1987, 16 separate bond issues with a face value of Rp. 536 billion ($317 million) had been issued publicly. All of the bonds were issued by public sector institutions -- BAPINDO, the state industrial development bank; P.T. Jasa Marga, the toll road authority; and P.T. Papan Sejahtera, a middle income housing finance institution. Jasa Marga has been by far the largest and most frequent issuer.

During 1988, private sector companies were allowed to issue bonds for the first time. A privately owned holding company and two joint ventures, a leasing company and a non-bank financial institution (NBFI), have done so and several others plan to sell bonds before the end of 1988 on both the stock exchange and over-the-counter market. Jasa Marga and BAPINDO also have issued new bonds this year, making 1988 the most active year ever for debt financings. The face value of bonds outstanding has increased by approximately Rp. 270 billion ($160 million) in 1988.

All financial institutions that trade securities on the stock exchange or the over-the-counter market must belong to PPUE. The membership now consists of 7 government, commercial and development banks, 11 private commercial banks, 9 non-bank financial institutions, 11 brokers and dealers, and Danareksa. Bank Indonesia is an honorary member.

Money Market. In the money market, SBIs, SBPUs and NBFI promissory notes remain the primary securities traded. Outstanding SBIs on March 31, 1987 amounted to $95.5 million. Government banks remain the largest buyers of SBIs. SBPUs have an active primary market but the secondary market is inactive and consists of little more than repurchase agreements. Approximately 70 banks and NBFIs sell SBPUs to Ficorinvest, an NBFI owned by Bank Indonesia, which either holds the securities until they are repurchased by the issuing bank or rediscounts them to Bank Indonesia. Bank Indonesia then holds the SBPUs until they are repurchased or mature. There is very little trading of SBPUs among the banks themselves. The total amount of SBPUs outstanding on March 31, 1987 was $571.5 million. At that same time, the total amount of NBFI paper outstanding was $583.5 million.

The effect of the increased use of these money market securities has been to stabilize the money market. Banks have reduced their dependence on the interbank market, causing interbank rates to become less volatile.

Commodities. The Indonesian Commodities Exchange (ICE) currently trades only rubber and coffee. Rubber is available either FOB or for local delivery, but coffee trades for local delivery only. Both commodities are traded only through physicals contracts. Futures contracts are not allowed. Physicals contracts can, however, be traded for future delivery because the ICE uses a retender system where contracts can be bought or sold as long as they have not matured. The ICE also trades U.S. textile import quotas.

Trading on the ICE has not progressed rapidly for a country that is the second largest producer of rubber in the world and one of the largest growers of coffee. During 1987 the ICE traded 12,700 metric tons of rubber FOB and 2,000 metric tons for local delivery valued at $9 million and $2.5 million, respectively, and 1,200 metric tons of coffee valued at $4 million.

2.2.3 Problems with and Prescriptions for Indonesia's Financial Markets

Indonesia's financial markets are underdeveloped. There is an extremely limited variety of securities traded in the money and capital markets, and there are no active secondary markets. Although activity has increased slightly recently, the role of the capital market remains very small. Funds still are mobilized primarily through the banking system. Since the banks' funds are short term, almost no long-term debt or equity finance is available. Furthermore, banks loan these funds based on collateral and personal relationships, not on projected cash flows. As a result, most companies are highly leveraged and small and medium-scale enterprises are virtually unable to obtain financing. Finally, the ICE cannot develop into an effective exchange until it allows futures contracts to be traded.

Overcoming these problems will require a broad range of actions. The following list ranks several of the more critical actions according to their importance.

2.2.3.1 Actions of Highest Importance to Address Financial Markets Problems

A) The tax treatment of bank deposits, which are currently tax-free, and capital gains, dividends and bond interest, which are taxed as regular income, should be equalized. This would increase the supply of funds in the capital market by increasing the effective (post tax) return on investments. The demand for funds would also increase because the cost of financing would decrease when investors would no longer have to be compensated for their tax exposure.

B) The regulatory process to approve the expansion of facilities or investment of additional capital should be quick and efficient.

C) Development of the capital and commodity markets has suffered because in each case a single government agency has been responsible for both operating and regulating the market. These responsibilities should be vested in separate organizations. The operational organization should operate, promote and self-regulate the market. The regulatory organization should have overall regulatory responsibility and must concur with the self-regulatory measures adopted by the operational organization. Furthermore, the division of responsibilities between MOF, BAPEPAM, PPUE and ICE should be clarified and the skills of the professionals involved in both operations and regulations should be strengthened.

D) A country-wide campaign should be mounted to provide investors, businesses and financial professionals with education and training in the capital market. When investors better understand both the need for diversified portfolios and the differences among interest income, dividend income and capital gains, capital flight should not only decrease but earlier flight capital should return to Indonesia. Firms should learn how to issue securities, and the rights and obligations resulting therefrom. Securities specialists should be trained through seminars, internships and technological transfer, perhaps via joint ventures with foreign brokerage firms.

2.2.3.2 <u>Actions of Medium Importance to Address Financial Markets Problems</u>

A) The SBI market should be expanded both in terms of the variety of securities offered and the number of financial institutions qualified to be traders. This would stimulate active securities trading and establish benchmark interest rates against which other debt securities could be priced. It also would indicate that the GOI supports development of the financial markets.

B) Institutional investors, such as pension funds and insurance companies, should be encouraged to follow prudent financial and actuarial practices and to invest part of their portfolios in medium- and long-term securities. They should be discouraged from investing predominantly short-term. They should also be able to establish and alter their investment policies as needed due to changing market conditions.

C) Accounting standards should be upgraded and Indonesian generally accepted accounting principles (GAAP) should be strengthened and promoted. This would improve financial disclosure standards, help ensure the proper initial pricing of and subsequent accounting for investments in securities and improve investor confidence in the capital market. It would also help ensure that trading is not stifled because investments in securities are incorrectly valued by accountants. It is common practice to account for investments in securities at their initial purchase price, not, as should be the case, at their current market value. If the securities have declined in value since their purchase, selling would result in the recognition of a loss which investors otherwise would not have to recognize. In other words, the prevailing accounting practices discourage trading, especially in a declining market.

D) The legal system should be modernized and legal standards upgraded. The system should allow for the perfection of a security interest. Security holders should feel that they can enforce their rights in court.

E) Banking practices and standards should be improved and bank access to credit information regarding potential clients should be expanded. Banks should be encouraged to follows prudent lending practices and to ensure that borrowers are not excessively leveraged. Firms seeking bank loans (especially government subsidized loans) should not be allowed to exceed specific debt/equity ratios and/or should be required to raise some of the funds through an accompanying issue of securities. When lending funds, banks should focus more on cash flow and less on the amount of the borrower's collateral. Relationships between companies and banks or other financial institutions should be regulated so that any loans or other transfers of capital between the two do not circumvent or undermine prudent banking practices.

2.2.3.2 <u>Actions of Least Importance to Address Financial Markets Problems</u>

A) Danareksa's role in the capital market should be evaluated. Its large ownership position, representing over 50% of all listed shares and over 30% of all listed bonds, and its mutual fund certificates, which guarantee a yield of 1% above time deposit rates and repurchase any time at par, can lead to distortions in securities prices and can prevent an active secondary market from developing. Danareksa's responsibility to maintain price stability can inhibit investment and trading. The MOF should consider allowing privately owned mutual funds to compete with Danareksa. Finally, Danareksa's role as both an underwriter and a mutual fund should be examined because of the potential conflicts of interest.

B) Investment opportunities available in Indonesia's capital markets should be promoted internationally and mechanisms and procedures should be instituted which can easily accommodate foreign investors.

C) The reluctance of Indonesian firms to disclose their financial statements and/or to diversify their ownership should be overcome through education and market development. Once the cost of capital in the financial markets becomes attractive relative to the cost of alternative sources of finance and the advantages of diversification obvious, these reluctances will more easily be overcome.

D) For the commodities market to become effective and active, commodity futures contracts should be introduced.

As is obvious, the development of Indonesia's financial markets depends on many diverse actions of varying importance. With reference to the above listed categories of "Highest, Medium and Least", the project will address some of these actions directly, some through policy dialogue, and some either not at all or only in a limited way. By providing education and training for regulators, financial professionals, investors and others, the project will directly address the problems of insufficient skills and knowledge (Highest C and D, and Least B and C). The project will provide technical assistance to overcome the problem of unsound or inadequate financial practices (Medium A, B and E, and Least A and D), and policy discussions to overcome regulatory problems (Highest A and B). The accounting and legal problems (Medium C and D) will not be directly addressed by the project, unless they happen to be included in future policy dialogue, in part because the World Bank and other international donors have projects in these areas. Because funds for education and training will be available before the long-term consultants are in place, some actions which require education and training will likely occur first. Once the consultants are residing in their counterpart organizations, training will continue and technical assistance will begin.

In conclusion, the preceding list of problems and prescriptions is not exhaustive and may not contain certain actions which the long-term consultants will determine to be critical. The training and technical assistance components of the project are designed to be sufficiently flexible so as to allow for the inclusion of unforseen actions and/or the exclusion of actions mentioned here which may later be determined to be of minimal importance.

3. PROJECT DESCRIPTION

3.1 PROJECT RATIONALE

The technical and financial analysis conducted for this project (see Annex E) confirms that at the present time in Indonesia, there is both a strong demand for long-term investment capital and an equally strong potential supply of capital. Nevertheless, public perceptions and regulatory and structural realities inhibit supply and demand from meeting freely in the marketplace.

Although the problems confronting Indonesia's financial markets are complex and largely structural in nature, they can be overcome through a combination of policy reforms by the GOI, some of which it has already initiated, and technical assistance and training focused on key regulatory and operating areas. The government's financial markets deregulation package of December 1987 provides strong evidence that the GOI recognizes and is committed to making the changes necessary to develop its capital markets and promote private enterprise. In a recent interview with the Far Eastern Economic Review, former GOI Coordinating Minister for Economic Affairs Ali Wardhana noted, however, that there is a gap between policy and implementation. He indicated that the will is there, but assistance and support in developing additional policy reforms and implementing those reforms are needed.

This project can be best described as institutional (both training and technical assistance) and policy implementation assistance directed at improving the investment, trading and regulatory environment for financial markets, particularly the capital market.* Our approach will focus on supporting continued GOI policy reforms which favor long-term capital formation and the strengthening of market forces, and on establishing a solid implementation basis for the expanded stock, bond, money and commodity markets, and for the infant brokerage industry. Inherent in this approach is that there are important reactive effects of strengthening the market, small as it now may be, in that success will lead to further deregulation.

The rationale for this project is clearly stated and supported in USAID's CDSS for FY 89 - FY 93. Major points emphasized in the CDSS which this project addresses include:

-- structural, long-term support for increased employment and incomes;
-- measures to increase efficiency and productivity of the economy;
-- support for a shift of resources from the public to the private sector; and
-- promoting a more open, market and trade-oriented economy.

Further, this project is of particularly high priority for the GOI because of its direct linkage to the promotion of non-oil production capacity and exports. While no other donors are working directly on the capital market, this project is also highly complementary to several related donor efforts and to the overall Inter Governmental Group on Indonesia (IGGI) goals of encouraging a less regulated, more productive economy. (A.I.D., GOI and other donor programs are discussed in more detail in Section 5.)

3.2 PROJECT GOAL AND PURPOSE

The goal of the Financial Markets Project is to increase the availability of long-term investment capital by supporting open financial markets. The project purpose is to increase the number of debt and equity securities and commodity contracts available to investors, and to increase the trading volume of these instruments.

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* An active capital market would also create a link between the public and private investment sectors, especially by providing an opportunity to sell equity shares in SOEs to individual Indonesian investors, employee groups, cooperatives or other private organizations. The approach to this project will therefore include support for SOE deregulation activities, perhaps including a future deregulation fund. Because the details of this fund are still under discussion, it is anticipated that it will be described and funded under a future project amendment.

3.3 PROJECT OUTPUTS

Major project outputs will be as follows:

3.3.1 Market Deregulation

A major portion of this project's resources will be directed toward support for continued GOI deregulation of financial markets and for adjusting the roles of the MOF, BAPEPAM, Danareksa, and Bank Indonesia (BI) as necessary to better regulate and promote the capital market. Conversely, the private sector, including PPUE, will gradually assume greater responsibilities for market development and operation. Throughout this project, the GOI will take the lead in initiating reforms, with project resources provided to support such actions. The major regulatory outputs and reforms which might be anticipated during the life of project, among others, are:

a. Reviewing BAPEPAM's regulatory and operational functions, and providing a clearer definition of the division of regulatory responsibilities among agencies involved.

b. Strengthening the technical capital markets skills of MOF and BAPEPAM staff, as required for their regulatory role.

c. Making, as possible, the fiscal and monetary regulations become more equal for long-term capital investment. This may include changes in pension and insurance investment guidelines, reviewing tax disincentives, evaluation and possible revision of BKPM investment rules, and recommendations on legal changes which would allow the perfection of a security interest.

d. Promoting Danareksa's role as a mutual fund for individual investors while reducing its favored status, restructuring its certificates and liquidating its unpledged portfolio.

e. Reviewing the operational and regulatory functions of the ICE, with the operational functions preferably being handled by the private sector.

Additional description and analyses of these organizations and the regulatory regime may be found in Annex E.

3.3.2 Increased Supply of Long-term Investment Capital

Although the total supply of capital in Indonesia is large, especially if "informal" capital flows are included, this output is directed at balancing the distribution of capital by increasing the flow of funds through the capital market into long-term investments. While several of the regulatory changes cited above will stimulate this process, there are policy, institutional and promotional actions which also will be addressed by the GOI. These include:

a. Developing standards and practices that encourage pension and insurance firms to diversify their portfolios and invest in debt and equity issues. This would cover not only company-specific policies but also implementation assistance to the GOI for the soon-to-be-enacted pension and insurance legislation, the development of which has been supported by the Agriculture and Rural Sector Support Program (ARSSP).

b. Reviewing bank reserve requirements and revising liquidity ratios to permit a wider range of reserve investments by banks.

c. Increasing investor interest in equities and bonds through educational and promotional campaigns.

d. Expanding individual and foreign investors' access to the capital market through: the establishment of national (a portfolio of Indonesian securities for domestic investors) and international (a portfolio of foreign securities for domestic investors) mutual funds as well as an Indonesian Fund (a portfolio of Indonesian securities for foreign investors); international linkage of the stock, bond and/or commodity markets; changing the structure of certain Danareksa fund certificates; and other mechanisms which would attract new investors.

e. Working with Bank Indonesia to issue a wider variety of bills, notes and bonds.

f. Creating a Bank Indonesia National Credit File, initially available to institutions but perhaps later to private investors as well, which will serve as an independent source of information concerning the creditworthiness of firms.

3.3.3 Improved Trading Capability and Structure

The major actors involved in trading securities are the brokers and dealers, underwriters, Danareksa and Bank Indonesia. The MOF is also involved through the regulatory process. The outputs of this project, in addition to the regulatory changes noted in Sections 3.3.1 and 3.3.2, will include actions to stimulate trading. While private sector securities firms should become self-sufficient in the medium-term, this project will support their development during the near-term when the market will be thin and the expertise lacking. Additional means of promoting the supply of securities will be to encourage the deregulation of state-owned enterprises (SOEs) through the sale of equities on the stock market, and to work with firms considering capital expansion but uncertain of financing alternatives. While the proposed SOE deregulation fund will be the subject of an FY 89 amendment, this action is still included below as an integral part of this project. Specific outputs will include:

a. Developing the private sector brokerage and underwriting industry through training and technical assistance and through the separation of the operational and regulatory functions of BAPEPAM and the ICE as cited in Section 3.3.1.

b. Encouraging the National Development Bank (BAPINDO), Regional Development Banks (BPDs) and the GOI Venture Capital Company (PT Bahana) to sell equity they hold in Indonesian companies through the stock market.

c. Establishing a nationwide automated central accounts function and check clearing system by continuing to support Bank Indonesia's ongoing program. (This program is currently receiving technical assistance from the Federal Reserve Bank of Dallas under the Private Sector Development Project (497-0329).)

d. Expanding the variety and number of firms granted access to trade in, Bank Indonesia money market instruments.

e. Encouraging the deregulation of SOEs through equity sales.

f. Supporting Danareksa's efforts to sell its unencumbered shares in companies listed on the stock exchange.

g. Improving private sector financial managers' awareness and skills in using capital and commodity markets to raise funds and stabilize prices.

h. Permitting futures contracts to be traded through the ICE.

3.4 PROJECT INPUTS

Inputs for this project will consist of technical assistance, training and commodities. In addition, there may be a deregulation fund to be described in the proposed FY 89 Amendment. Promotional support, although a somewhat distinct input, is broken down below into its technical assistance, training and commodities components.

3.4.1 Technical Assistance

The technical assistance team to be established under the project will act as a project management unit with responsibility for managing and coordinating all inputs including training and commodities. Likewise, the team will be responsible for the full range of project outputs, encompassing elements of policy implementation, institutional development and promotion.

The core team will consist of six long-term experts reporting to the Director General for Monetary Affairs, MOF. The team (here called the MOF team) will consist of the following:

a. Chief of Party/Regulatory Advisor — This person will be responsible for advising the GOI on all aspects of regulatory reform as noted in Section 3.3.1 and shall act as team coordinator and manager of the training and commodity inputs.

b. Deputy Chief of Party/Regulatory Advisor — Acting as the Chief of Party's alter ego, this position will be reserved for an Indonesian professional well versed in the local legal and regulatory systems who can help ensure that documentation and recommendations are appropriately designed and structured for Indonesia.

c. Investment Analyst — This expert will work primarily with investors, especially the pension and insurance companies and Danareksa, on portfolio management and promotion programs.

d. Trade and Underwriting Specialist -- This person will work closely with the private brokers and underwriters, PPUE, and private firms desiring to list on the markets. He/she will also develop educational programs for market promotion.

e. Training/Promotions Manager -- This person will arrange for and manage all short-term training programs, promotional campaigns and local/regional seminars and workshops as described in Section 3.4.2.

f. Administration/Logistics Manager -- This person will coordinate and manage all aspects of commodity procurement for the project and logistical support for the team.

The MOF team will be augmented by substantial short-term expertise. It is anticipated that this short-term assistance will be jointly funded by this project and the PRE Bureau Financial Markets Project. The total level of short-term assistance for the project team is estimated at 60 person months, of which we anticipate the PRE Bureau will finance 25 percent under buy-in arrangements. These arrangements will consist of USAID preparing PIO/Ts for submission to AID/W for contracting action. Short-term assistance anticipated during the life of project under this team is:

+ Deregulation of SOEs	-- 24 p/m
+ Commodity Market Experts	-- 12 p/m
+ Stock/Bond Experts	-- 12 p/m
+ Pension/Insurance Experts	-- 6 p/m
+ Regulatory/Legal Experts	-- 6 p/m

An Indonesian sub-contractor will also be associated with the MOF team. This firm's responsibilities will include the actual conduct/implementation of all promotional campaigns, workshops and seminars to be held in Indonesia. This sub-contractor will be supervised by the MOF team Training/Promotions Manager. Specific tasks will include developing TV, radio and/or newspaper advertising and promotional campaigns sponsored by the GOI and the individual financial markets, and handling publicity and logistics for local workshops and seminars.

In addition, Bank Indonesia will be assisted by one long-term Senior Banking Expert who will report directly to the central bank and be responsible for all aspects of Bank Indonesia development programs noted under the outputs above. This expert will also manage short-term technical assistance inputs for Bank Indonesia priority programs. This short-term assistance is expected to total approximately 60 person months over the life of the project, with PRE Bureau also providing 25 percent of the cost of these short-term experts. The estimated breakdown of short-term technical assistance for Bank Indonesia is as follows:

+ Automation/Data Telecommunications	-- 30 p/m
+ National Credit File	-- 24 p/m
+ Money Markets	-- 6 p/m

Bank Indonesia training programs will be funded under the BI contract, but will be administered by the MOF team Training Manager at the request of Bank Indonesia.

The Scopes of Work for the technical assistance can be found in Annex D.

3.4.2 Training

There will be a major training program under this project, comprised of short-term overseas training, and local workshops and seminars. The proposed content of these programs is as follows:

Short-term overseas training will be provided for approximately 150 participants over the life of the project. This training will be targeted at the regulatory agencies--MOF, BAPEPAM, Bank Indonesia and the ICE; institutional investors, especially pension and insurance companies; and the underwriting/trading sector, including PPUE, brokers and dealers, and Danareksa. Regulatory participants will focus on training through organizations such as the SEC, Federal Reserve, FDIC, and U.S. Treasury. Institutional investors will receive training through organizations such as major banks and investment houses, pension and insurance firms, and training or regulatory bodies involved in the investment field. The issuer/trader training would be targeted at major brokerage houses, mutual funds, NASD (which operates the U.S. OTC market) and similar trading organizations.

Assuming the average overseas short-term training period will be one month, Table 1 shows the estimated training person months per project year for the three above mentioned trainee categories.

TABLE 1: SUMMARY OF SHORT-TERM OVERSEAS TRAINING
(Person Months per Year)

Organization	Project Year 1	2	3	4	5	6	Total
REGULATORY AGENCIES	5	20	10	5	5	5	50
INSTITUTIONAL INVESTORS	5	10	10	10	10	5	50
ISSUERS/TRADERS	5	10	10	10	10	5	50
TOTAL	15	40	30	25	25	15	150

The selection of trainees will be jointly decided by MOF, Bank Indonesia, the MOF advisory team and BI expert, with annual training plans being prepared by each participating agency. As noted above, the MOF advisory team will be responsible for the implementation and backstopping of all training programs. The GOI will be expected to finance international air fare for all GOI employees. All private sector participants will be trained on a cost-sharing basis, with the private sector paying a minimum of 25% of total training costs. A.I.D. Handbook 10 shall apply for all overseas training.

Local workshops and seminars will be especially important in terms of increasing public awareness of the benefits of diversified financial markets and reinforcing a positive image as changes are introduced; informing and educating investors of the process and opportunities relating to new investments; and presenting private businesses needed information on the process and benefits of raising capital through the financial markets. We anticipate four or five major workshops and seminars per year, some of which will be presented several times in regional centers such as Surabaya, Medan, Bandung, Ujung Pandang and Denpasar to help promote investment and business growth throughout Indonesia. As noted in the Technical Assistance section above, these programs will be developed and managed under the MOF consultancy team.

In addition to the foregoing workshops and seminars, the project will sponsor a pre-implementation seminar in October or November 1988, which will cover basic implementation issues, to include project impact tracking. Participants will include all relevant parties to project implementation, e.g., MOF, Danareksa, PPUE, Bank Indonesia, Bapepam.

3.4.3 Commodities

There will be a relatively small commodity procurement program under this project, to be funded and managed through the consulting contracts. Commodities will consist of microcomputer hardware and software to assist PPUE or its operational equivalent in establishing its broker and dealer network and the ICE in its trading activity needs; promotional materials and advertisements related to the educational campaigns for investors and listers; and limited support commodities for the consulting personnel such as vehicles and computers. Initial estimates have been prepared by Ernst and Whinney under a local IQC for the computer needs of PPUE and under other contract arrangements by Powers Research, Inc., for the ICE. However, since the regulatory and operational environment of the exchanges may be modified during the initial phase of the project, USAID will review the approved business plans for PPUE and the ICE prior to procurement of computers or software. Further details on commodity purchases and budget can be found in Section 4.

3.5 END OF PROJECT STATUS

By the end of this project, in September 1994, we anticipate that the results set forth in Table 2 will have been achieved. The plan for evaluating the progress made toward achieving these results can be found in Section 8.

TABLE 2: ANTICIPATED END OF PROJECT STATUS

End of Project Status	Current Status	Means of Verification
1. A permanent and long-range regulatory environment for stocks, bonds and commodities will have been established with operational responsibilities separated from regulatory authority.	1. BAPEPAM and ICE both regulate and operate their respective markets. Private dealers (PPUE) have yet to list any securities.	1. Operational charts for BAPEPAM and ICE. Operational statistics for PPUE or brokers.
2. At least five private broker/dealers will be able to operate profitably from broker/dealer business alone.	2. Although there are about 20 broker/dealers, only one is able to profit from broker/dealer business alone.	2. Income statements, PPUE or BAPEPAM statistics.
3. At least one new stock and two new bond issues will be marketed each month, with average daily stock trading volume reaching 50,000 shares per day, and total stock and bond market capilization increasing to at least Rp. 5 trillion.	3. No new stock issues since 1984. Average daily trade is 8,000 shares. Total stock and bond assets are almost Rp. 1 trillion.	3. BAPEPAM/MOF/PPUE statistics.
4. Commodity futures and at least two new commodities will be traded on the ICE.	4. Commodity futures trading currently not authorized. Only rubber and coffee are traded.	4. ICE, Ministry of Trade records.
5. A nationwide automated check-clearing system will be operational.	5. Checks are cleared manually through a central clearing house.	5. Bank Indonesia records.
6. Pension and insurance companies will grow by 50% and increase total stock and bond holdings to 30% of their portfolios, representing Rp. 3 trillion.	6. Stock and bonds now account for less than 10 percent (Rp. 650 billion) of insurance and pension fund investments.	6. MOF records.
7. Danareksa will reduce the percentage of [illegible] rtfolio which is unpledged a[illegible] re and increase [illegible]	7. Fifty [illegible] Danareksa's equity portfo[illegible] ed. Danareksa's cert[illegible] a [illegible] aranteed return and [illegible] and only 14% [illegible] s.	7. Danareksa, MOF statistics.

4. FINANCIAL PLAN

The total budget for this project is $12.0 million, comprised of A.I.D. grant funds of $9.0 million and local contributions of $3.0 million (equivalent). Local contributions are to include cash and in-kind inputs from both the Ministry of Finance and Bank Indonesia and cash inputs from PPUE, pension and insurance firms, and other private sector participants. Budget calculations are based on the following:

Technical Assistance. The umbrella technical assistance contracts with MOF and Bank Indonesia are to extend over five years. Although virtually all project funds except the in-kind support, private sector contributions, and evaluation/audit and contingency funds will be provided through the umbrella contracts, the contract budget will be segmented to track technical assistance, training and commodities expenditures.

Long-term advisors have been budgeted at $215,000 per year, inclusive of allowances, overhead, fees and other direct costs. This is believed to be a reasonable average cost, although several of the lead advisors may well have relatively high salaries given the salary levels of experts in the financial sector. It is anticipated there may be a need for at least one salary waiver to exceed the FS-1 pay cap. Short-term salaries are budgeted at $15,000 per month including all expenses, this again being an average only. The budget for the local subcontractor for promotions/workshops is estimated at $70,000 per year for 5 years.

MOF and Bank Indonesia will provide $1,250,000 in direct contract costs to support the technical assistance teams. In addition, they will provide in-kind contributions valued at $400,000, which will consist of office space, furniture and equipment, and local staff support for the teams.

Training. Short-term overseas training is estimated at $10,000 per month based on an average one-month training period. This budget figure covers air fare, per diem, tuition cost and miscellaneous expenses. All air fares are to be paid under the local contribution portion. All per diem shall be at standard A.I.D. rates. Tuition costs will vary widely, but again are anticipated to be relatively expensive from our experience in financial sector training.

Workshops and seminars, totalling approximately 60 over the life of the project (including seminars repeated in several regional centers), are estimated to cost $10,000 each. Approximately 50% of this cost will be borne by participation fees for private sector attendees.

Commodities. The PPUE and ICE computer procurement is estimated to cost $500,000, which includes all hardware, UPS, LAN server, software development (subcontract), maintenance and training. PPUE costs will be shared 50/50 between A.I.D. and PPUE. Cost-sharing between A.I.D. and the ICE, a GOI entity, is covered under normal counterpart funding arrangements of the grant. Publications, advertisements, TV and radio promotions are budgeted at $70,000 per year for 5 years. The consultant support commodities include up to four work vehicles and microcomputers/word processors for the office.

Life of project funding estimates are given in Table 3. Table 4 illustrates the estimated value of the inputs as they relate to specific outputs. Tables 5 and 6 provide the schedule of estimated annual obligations and commitments, and disbursements respectively, for the life of project. It should be noted that all commitments will be made well within an 18-month period after obligation, the technical assistance contracts being the only major commitments planned.

Method of Financing. In Table 3 it should be noted that, subject to a successfull USAID review of GOI contracting procedures, all items under Technical Assistance, Training and Commodities will be funded under host country technical assistance contracts (HCCs). All HCC payments will be made by A.I.D. directly to the contractors, based on MOF certification. Prior to executing the umbrella HCCs, some limited, direct A.I.D. contracting for selected training and short-term technical assistance may also occur. Evaluations and audits will be paid by direct payment procedures using A.I.D. direct contracts.

TABLE 3: TOTAL PROJECT FUNDING BY COMPONENT ($000)

COMPONENT	A.I.D.	MOF	BI	OTHER 1/	TOTAL
1. TECHNICAL ASSISTANCE					
a. Long-Term:					
10 p-y x $225,000/year (2 Team Leaders)					
5 p-y x $110,000 (Deputy Chief of Party)					
15 p-y x $170,000 (Investment, Trading and Training Experts)					
5 p-y x $20,000 (Admin/Logistics Mgr.)					
Sub-total	5,450	750	250	—	6,450
b. Short-Term: 2/ 90 p-m x $15,000/month	1,100	—	250	—	1,350
c. Promotion Subcontract 5 years x $70,000	350	—	—	—	350
d. In-kind Support	—	250	150	—	400
2. TRAINING					
a. Short-Term Overseas 150 months x $10,000	750	200	100	450	1,500
b. Workshops/Seminars	300	—	—	300	600
3. COMMODITIES					
a. Computers/Software	250	--	--	250	500
b. Publications/Ads	350	—	—	—	350
c. T/A Vehicles, Equip.	100	—	—	—	100
4. EVALUATIONS/AUDIT	200	—	—	—	200
5. CONTINGENCY	150	50	—	—	200
TOTAL	9,000	1,250	750	1,000	12,000

1/ PPUE and other private sector participants.
2/ Excludes approximately 30 p-m to be centrally-funded under PRE Bureau Financial Markets Project.

TABLE 4: COSTING OF PROJECT OUTPUTS/INPUTS ($000)

	INPUTS	PROJECT OUTPUTS			
		DEREGU-LATION	INVESTMENT SUPPLY	TRADE CAPACITY	TOTAL
A.I.D.:	Technical Assistance	2,200	1,900	2,800	6,900
	Training	350	350	350	1,050
	Commodities	100	200	400	700
	Evaluation	75	50	75	200
	Contingency	50	50	50	150
	Sub-Total	2.775	2.550	3.675	9,000
GOI.	Technical Assistance	550	550	550	1,650
	Training	350	350	350	1,050
	Commodities	—	—	250	250
	Contingency	50	—	—	50
	Sub-Total	950	900	1,150	3,000
TOTALS		3,725	3,450	4,825	12,000

TABLE 5: ESTIMATED ANNUAL AID OBLIGATIONS/COMMITMENTS ($000)

INPUTS	FY88 OBL/COM	FY89 OBL/COM	FY90 OBL/COM	FY91 OBL/COM	FY92 OBL/COM	FY93 OBL/COM	FY94 OBL/COM	TOTAL LOP
Technical Assistance	3,447/0	0/3,447	1,953/1,953	0/0	1,500/1,500	0/0	0/0	6,900
Training	500/0	0/500	300/300	0/0	250/250	0/0	0/0	1,050
Commodities	200/0	0/200	500/500	0/0	0/0	0/0	0/0	700
Evaluation	0/0	0/0	100/100	0/0	100/100	0/0	0/0	200
Contingency	0/0	0/0	0/0	0/0	150/150	0/0	0/0	150
TOTALS	4,147/0	0/4,147	2,853/2,853	0/0	2,000/2,000	0/0	0/0	9,000

TABLE 6: ESTIMATED ANNUAL AID DISBURSEMENTS ($000)

INPUTS	FY88	FY89	FY90	FY91	FY92	FY93	FY94	TOTAL
Technical Assistance	-0-	400	1,000	1,300	1,400	1,400	1,400	6,900
Training	-0-	200	250	250	150	100	100	1,050
Commodities	-0-	150	250	100	100	50	50	700
Evaluation	-0-	-0-	50	50	-0-	50	50	200
Contingency	-0-	-0-	-0-	-0-	50	50	50	150
TOTALS	-0-	750	1,550	1,700	1,700	1,650	1,650	9,000

5. A.I.D., GOI AND OTHER DONOR PROGRAMS

This section describes the relationship of the Financial Markets Project to A.I.D., GOI and other donor programs and priorities.

5.1 A.I.D. PRIORITIES

Financial markets development relates directly to A.I.D.'s overall goal of promoting broad-based and sustainable income growth and employment generation, and more specifically to the promotion of the private sector as the most efficient means of attaining growth in income and employment. Firmly linked to those overall goals is the Financial Markets Project's goal of increasing the availability of long-term investment capital by supporting open financial markets.

In January 1988, A.I.D. issued a draft policy paper on financial markets, indicating its growing awareness of the critical role these markets have in a well functioning private sector. This paper particularly stresses the role which financial markets play in mobilizing domestic resources, integrating domestic and international financial systems, and promoting democratic institutions and widespread ownership. The draft policy paper goes on to stress policy and institutional development as the key potential A.I.D. interventions in financial markets. In reviewing this policy document, it is concluded that not only is USAID's proposed Financial Markets Project fully consistent with A.I.D. policy but it also is on the leading edge of A.I.D.'s evolving private sector strategy. As such, we believe a successful financial markets project in Indonesia will provide valuable input into future A.I.D. programs worldwide.

USAID/Indonesia's Country Development Strategy Statement (CDSS), completed in January 1988, sets the stage for USAID's five-year program for FY 89-FY 93. Given the current progress and potential of Indonesia's private sector, the CDSS strongly reflects A.I.D.'s overall strategy of achieving income and employment growth by increasing the role of the private sector and open markets. In support of the Mission-wide goal of employment and growth, efficiency and productivity are cited as the primary means of achieving this goal. Financial markets development, by its impact on the efficiency and productivity of both financial markets and productive enterprises, stands as one of the central project interventions in USAID's five-year plan. This is supported in the CDSS by explicit references to opening financial markets throughout the sub-goal entitled "Support a more open, less regulated market and trade oriented economy, internally and externally."

The CDSS also establishes several program criteria which are to be emphasized over the next five years. These are:

I. <u>More attention to macro, structural, sectoral and cross-sectoral concerns</u> — As is addressed in various sections throughout this PP, financial markets development will have a broad, macro and multi-sectoral impact. This impact should extend well beyond the financial sector itself, producing long-term benefits for other A.I.D. sectors including agriculture, health and education. Mission projects which will benefit include the Housing Guarantee Program due to the role of the capital market in creating a more favorable public investment climate; the proposed Agribusiness Project due to the promotion of new investment in agribusiness; and the Health Sector Financing Project due to the support for the health insurance industry.

2. More attention to leveraging and management effectiveness principles -- Leveraging principles have two separate contexts. First, one of the primary reasons both investors in and issuers of securities use financial markets is to leverage funds, that is invest borrowed funds at a yield greater than their cost. Our participation in this sector is, therefore, an excellent example of leveraging additional funds in the project sense. This is further analyzed in the economic analysis, Section 7.

Leveraging also refers to the ability to bring other resources, such as donors, into a sector through our inputs. In this instance, both the Asian Development Bank (ADB) and the International Finance Corporation (IFC) will likely be programming funds in the finance sector partially based on USAID's decision to support this sector. (See also Section 5.3.)

With respect to management effectiveness, this project's design has taken into consideration the following points.

- Institutions targeted for development, including BAPEPAM, PPUE and Danareksa, are relatively small and have very specific tasks to perform. In addition, these institutions operate within an increasingly private sector environment which stresses efficiency in order to succeed. Taken together with the fact that the GOI is truly committed to making the financial markets work, we conclude the institutional development targets under this project are achievable within the life of project and will not require additional management inputs other than those associated with the proposed technical assistance team.

- Care has been taken throughout the design process to ensure that inputs are interrelated, manageable, and under the control of the "umbrella" MOF contractor to the greatest extent possible. Since very little of the work will take place outside of Jakarta, the management load is accordingly reduced. Also, the existence of the GOI Capital Markets Policy Committee will reduce the need for inter-ministerial negotiations by USAID.

3. More sustained use of program assistance -- Given the relatively underdeveloped state of Indonesia's capital market, we conclude that this sector is not yet appropriate for sector or program assistance. Nevertheless, should the proposed deregulation fund demonstrate itself as an effective component of the GOI deregulation program, the possibility of expanding this component into a program, either as an amendment to this project or a new program, should be considered.

5.2 GOI PRIORITIES

Recently, there have been many articles in the local newspapers concerning the need for improving Indonesia's financial markets. In a major speech on July 5, 1988, Minister of Finance Dr. J.B. Sumarlin outlined in detail the potential role and need for improvements in the capital market. A December 1987 GOI deregulation package substantially reformed the capital market and created a new OTC market--the Bursa Paralel. It is noteworthy that financial markets development enjoys broad-based support and is seen as either positive or at least neutral by all interest groups.

Thus, while there are specific elements of sensitivity within the overall plan, such as tax revisions and deregulation of SOEs, there is general widespread support throughout the GOI and the private sector for a major financial markets initiative. This will be spurred on by the increasing pressure to promote non-oil exports and employment opportunities. Although we do not yet know what the exact content of the GOI Repelita V will be, we fully anticipate that when published it will explicitly include support for improved capital markets in a manner consistent with steps outlined in this project.

5.3 OTHER DONOR PRIORITIES

Three major donor organizations have a stated or ongoing interest in financial markets development--the World Bank, ADB and IFC. Their interests are as follows:

The World Bank. A May 1988 Bank report cited trade policy reforms, enterprise deregulation and financial sector development as the three sectors where continued policy development for structural change is of highest priority.[1] Within the financial sector, the World Bank pointed to the need for improved capital markets, for lowering the cost of financial intermediation and for reducing high interest rates, all of which are all directly addressed by the project. A fourth Bank priority--restructuring problem loans in major industrial sectors--may be affected by the proposed FY 89 deregulation fund.

The second activity is a proposed program loan for the financial sector. This loan would be targeted toward balance of payments support and resolution of problem loan portfolios in the banking system. At this point, it is unclear what the policy content of this loan will be. USAID regularly meets with the financial sector team from Manila during their visits to Jakarta, and will help ensure the compatibility of our efforts. At this point, there appears to be little overlap.

The Bank's lending activities in the financial sector are comprised of a new Accountancy Project and a proposed medium-scale industry credit loan. The Accountancy Project has as its primary target the establishment of professional standards and certification procedures for all accountants in Indonesia. One aspect of this will be approximately one person-year of assistance to BAPEPAM, plus related training. USAID has been in close contact with the World Bank on this technical assistance component, and envisages no duplication of effort. The Bank's assistance will focus on accounting and listing standards for individual stocks and on improving BAPEPAM accounting procedures.

The Bank will also be conducting a major Indonesian financial sector study in 1988-89. USAID is coordinating with the resident World Bank advisors to provide information from our project for the study. We would mutually benefit from the study results, especially as input for project monitoring and evaluation.

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1 Indonesia--Adjustment, Growth and Sustainable Development. World Bank Report No. 7222-IND.

The Asian Development Bank. The ADB has two planned activities for the financial sector. The first is the Asian Development Equity Fund (ADEF) which is an Asian-wide $100 million investment fund to be invested approximately 70% in developed exchanges and 30% in developing exchanges such as Jakarta. In addition to ADB, several major Japanese and U.S. investment banks are involved in underwriting and managing the ADEF. To date, there has been no investment in Indonesian stocks, but it is anticipated that up to $5 million may be invested in the near future. Our assistance to the market would certainly strengthen the case for ADEF participation in Indonesia.

The International Finance Corporation. As the private sector lending arm of the World Bank, IFC is interested in promoting the entrance of international mutual funds into Indonesia's capital market. While it is too early to predict if and when this might occur, any significant improvement in the markets will likely tip the scale enough to bring in the IFC and several other large sources of private investment funds into Indonesia. The development of the capital market is particularly important to the IFC because it would provide a means for IFC to sell the shares it holds in many local ventures to the Indonesian public.

As in the past, USAID/Indonesia's Office of Private Sector Development will continue to carry on regular working level contacts with the aforementioned donors in order to share information on their and our project activities. This coordination should mutually reinforce financial markets activities either in the planning or implementation stages.

6. SUMMARY TECHNICAL AND FINANCIAL ANALYSIS

Because of the financial nature of this project, the technical and financial analyses have been combined, and in fact are indistinguishable. This section summarizes the technical and financial analysis found in Annex E. Annex E covers analyses of the demand for capital, sources (or supply) of investment capital, risk factors in the various markets, and the present trading and regulatory system, and has separate analyses of the money and commodities markets and Danareksa operations. A brief summary of supply, demand and risk factors is set forth below.

6.1 DEMAND FOR CAPITAL

While there is no easy way to measure the potential demand for capital in Indonesia, there are many indications that it is quite strong. Demand is most easily evidenced by the continuous increase in corporate bank debt, which represents the primary source of funding in the economy. Currently, the Indonesian banking system provides over 90% of total debt financing, gathering almost 22% of total invested funds in the form of savings deposits.

A second indication of demand is the large backlog of investment applications with the Investment Coordinating Board (BKPM). These applications represent both new investment and expansion requests. Many of these applications, however, are in search of foreign partners for investment funds, and are not progressing.

A third indication of demand is the current level of interest rates. Commercial interest rates of 22-25% have persisted ever since the ceiling on rates was lifted in 1984 and there appears to be no significant change in sight. The strong demand for investment loans at these rates, especially in a free foreign exchange environment, is a clear sign of strong demand.

A final signal is the increased activity in the bond market. This applies to both the public and private sectors. In the public sector there is widespread discussion of the possible use of bonds, build-operate-and-transfer, or other financing arrangements to meet the demand for investment capital. Examples discussed in Annex E are telephone, housing, utility, construction and public service bonds. The private sector has also recently shown increasing interest in commercial bonds, despite the remaining tax disincentives and the underdeveloped nature of the bond market.

Over the next ten years the requisite increase in private sector investment alone is approximately $52 billion, as estimated by the World Bank. Thus, what appears to be an ambitious target of a five-fold increase in the total capitalization of the stock and bond markets in the project EOPS, to a total of roughly $3 billion (equivalent), may be conservative. While other sources of capital will partially help to meet investment needs, the probable large unmet demand for funds lends a sense of urgency to the need for capital market reform and development.

6.2 SUPPLY OF CAPITAL

As a result of reforms initiated in 1983 the gross assets of the organized financial sector have since tripled, representing an annual growth rate of nearly 23%. These gross assets now total approximately $55 billion, or over 75% of Indonesia's GDP. The net effect has been a tremendous shift of Indonesia's financing assets from informal markets into the formal financial system.

One of the major benefits of capital market development will be to support continued growth of the formal financial system by providing a more varied and attractive array of formal investment opportunities. Currently a 2% increase in the formal financial system would represent close to $1 billion of new investable capital.

Within the financial system the supply of capital for long-term investment is most dependent on attracting funds away from short-term sources, especially time deposits. Pension and insurance companies, whose liabilities are almost exclusively long term, are an especially appropriate source of long-term capital for the markets. At present the pension funds, perhaps 500 large and small funds, have investable funds of approximately $3 billion (equivalent). Insurance companies, totalling 107 firms and including the major GOI and armed forces social insurance funds, have roughly $1 billion in investment capital. Pension and insurance companies now have less than 10% of their portfolios (Rp. 650 billion) in stocks and bonds. Therefore, the potential supply of capital from pension and insurance companies is probably sufficient to meet most, if not all, of the near-term demand for funds.

Another potentially large source of capital is foreign investors. While current regulations greatly restrict the ability of foreigners to invest in Indonesia, except through joint venture businesses, such restrictions are beginning to be lessened. As noted in Section 5.3, several private and donor-sponsored mutual funds are considering investing in Indonesia.

Individual investors, especially wealthy investors desiring to diversify their portfolios, may also become an increasingly important source of capital. While individuals in middle and lower income groups do not represent a major source of capital, organizations such as Danareksa will provide such individuals an opportunity to invest for such long-term needs as their children's education through stocks and bonds.

6.3 RISK FACTORS

In an open market environment several types of risk are reflected in the level of interest rates. This includes the risks of devaluation, inflation and default, the first of which has been instrumental in maintaining high commercial interest rates in Indonesia. The risk of default resulting from the mismatch between short and long-term assets and liabilities will be greatly reduced through capital market development. This risk leaves the health of the economy especially vulnerable to short-term financial shocks.

The risks inherent in investing in equities are considerable. Equity capital is risk capital because whether investors are paid a dividend is predicated on the ability of the firm to grow and earn income. Such risk capital can and should play an important role in Indonesia's needed expansion of productive capacity. Additional risks associated with individual securities include improper or incomplete disclosure by the issuer, or manipulation of price by one or more major investors. These risks are magnified in a small market which can more easily be manipulated; yet they are somewhat balanced by the fact that abuses should more readily be detected in a small market. Clearly, the regulatory system needs to provide safeguards which help prevent abuse. Both this project and the World Bank accountancy loan will assist in creating an improved regulatory environment and improved financial disclosure. Ultimately, however, investors must be educated, perhaps through training in portfolio management, to the risks and benefits inherent in investing in the capital market.

While bonds are generally less risky than equities, the present inability of creditors to enforce their rights under the Indonesian legal system increases the risk of investing in bonds and other debt instruments. While the legal system is outside the scope of this project, the project will at least present a forum to better publicize these legal issues.

7. SOCIAL, ECONOMIC AND ENVIRONMENTAL ANALYSIS

7.1 TARGETED BENEFICIARIES

The Financial Markets Project is not targetted at a specific community or social group, but rather at two large, encompassing economic sectors: users of capital and providers of capital. Beneficiaries within those two sectors are described below.

7.1.1 Users of Capital

All businesses are users of capital. Any firm, no matter how small or big, needs capital to operate on a daily basis and to invest for the future. Any firm which depends on outside sources for capital should ultimately benefit from the project.

Manufacturing firms tend to be heavy users of capital and depend on their access to capital to allow them to invest in equipment needed for production. Even manufacturing processes which are labor intensive require a minimal amount of plant and equipment. Manufacturing firms also need capital to conduct day-to-day business. Thus, manufacturing firms will benefit significantly from the project.

A 1985 census of the manufacturing sector indicated that there were 12,902 large (over 100 employees) and medium (20-94 employees) firms, 98,129 small (5-19 employees) firms and 1,442,593 household and cottage (4 or less employees) firms. Almost 93% of the manufacturing firms in Indonesia have less than five employees, 6% have 5-19 employees and only 1% have over 20 employees.

Most industries within the manufacturing sector in Indonesia follow this distribution and are predominantly comprised of very small firms. This includes such industries as food processing, beverages and tobacco; textiles; wood and wood products; non-metal minerals; and fabricated products. Three industries, however, noticeably differ from this general distribution by having a high percentage of large firms. All 30 firms in the basic metals industry are large and medium. In the chemical, oil, coal, rubber and plastic industry, 14% of the firms are large and medium and 21% are small. The paper, printing and publishing industry also differs from the norm in that 5% of the firms are large and medium and 22% are small. Because more of the firms in these industries are large and medium relative to the other industries, larger firms tend to require more capital than smaller firms. Because these industries tend to be capital intensive, they will unquestionably benefit from the project. It should be noted that the firms in these industries employ approximately 7% of the total manufacturing work force, and 15% of the workers in large, medium and small firms.

It is important to realize that not just the large and medium firms will benefit. While the larger firms generally require more capital, by virtue of their size and reputation they usually have better access to capital. The project will help broaden the financial markets so as to provide finance to smaller firms which currently have difficulty finding the capital necessary to invest and grow. Traditionally, it has been very difficult for small Indonesian firms to grow because they lack the 200-300% collateral required by banks for loans. These firms will benefit because their potential sources of capital will increase and the conditions for gaining access to this capital will improve. A summary of manufacturing establishments by size and number of employees can be found in Tables 7 and 8.

Large producers of commodities such as rubber, coffee and, perhaps eventually, palm oil and copra also will directly benefit from the project. Because the production of these commodities in Indonesia is predominantly under nucleus estates, involving hundreds of thousands of small farmers, these individual farmers will also benefit significantly from a more stable price environment, increased investment and stronger demand. To take rubber as an example, 82% of the land under cultivation and 67% of the total production comes from smallholder farms.

TABLE 7: SMALL, MEDIUM AND LARGE MANUFACTURING COMPANIES: NUMBER OF ESTABLISHMENTS BY SIZE GROUP (1986)

	NO. OF ESTABLISHMENTS				PERCENT OF ESTABLISHMENTS		
INDUSTRY GROUP	LARGE AND MEDIUM	SMALL	HOUSEHOLD/ COTTAGE	TOTAL #	LARGE AND MEDIUM	SMALL	HOUSEHOLD/ COTTAGE
Food, beverages, tobacco	3,880	36,953	443,796	484,629	1%	8%	92%
Textile, wearing apparel, leather	2,869	14,865	149,336	167,070	2%	9%	89%
Wood, wood products including furniture	1,204	15,501	487,135	503,840	0%	3%	97%
Paper, paper products, printing, publishing	604	2,706	9,136	12,446	5%	22%	73%
Chemical, petroleum, coal, rubber products	1,626	2,552	7,844	12,022	14%	21%	65%
Non-metallic mineral products except petroleum and coal	1,249	12,148	105,907	119,304	1%	10%	89%
Basic metals	30	0	0	30	100%	0%	0%
Fabricated metal products, machinery, equipment	1,283	4,901	34,403	40,587	3%	12%	85%
Other	157	8,503	205,036	213,696	0%	4%	96%
Total	12,902	98,129	1,442,593	1,553,624	1%	6%	93%

TABLE 8: SMALL, MEDIUM AND LARGE MANUFACTURING COMPANIES:
NUMBER OF EMPLOYEES BY SIZE GROUP (1986)

INDUSTRY GROUP	NO. OF EMPLOYEES: LARGE AND MEDIUM	SMALL	HOUSEHOLD/ COTTAGE	TOTAL #	PERCENT OF EMPLOYEES: LARGE AND MEDIUM	SMALL	HOUSEHOLD/ COTTAGE
Food, beverages, tobacco	519,449	281,457	1,077,435	1,878,341	28%	15%	57%
Textile, wearing apparel, leather	381,360	122,010	210,620	713,990	53%	17%	29%
Wood, wood products including furniture	181,883	111,600	765,600	1,059,083	17%	11%	72%
Paper, paper products, printing, publishing	56,680	23,156	17,270	97,106	58%	24%	18%
Chemical, petroleum, coal, rubber products	248,631	22,522	13,514	284,667	87%	8%	5%
Non-metallic mineral products except petroleum and coal	88,995	89,326	265,835	444,156	20%	20%	60%
Basic metals	15,647	0	0	15,647	100%	0%	0%
Fabricated metal products machinery, equipment	179,375	36,842	87,640	303,857	59%	12%	29%
Other	12,015	63,398	414,276	489,689	2%	13%	85%
Total	1,684,035	750,311	2,852,190	5,286,536	32%	14%	54%

7.1.2 Providers of Capital

The users and providers of capital represent opposite sides of the same equation. If one side benefits, so does the other. The providers of capital who will benefit most are institutional investors, such as pension funds and insurance companies, and individuals. In addition, the benefits that accrue to institutional investors will also benefit their policy holders.

The government, the armed forces, state companies, banks and many private companies have established pension funds. There are currently as many as 500 pension funds. The largest such fund, P.T. Taspen, had over 3.2 million participants and the military pension fund, Perum AKABRI, had almost 630,000 participants in 1985. On the average these pension funds invest 73% of their assets in short-term time deposits, 10% in stocks and bonds, 10% in real estate and 7% in other investments. In other words, pension funds are predominately invested short-term and, as a result, it is impossible for the managers of the funds to ensure that the funds are actually sound. Because pension fund managers cannot calculate the future value of their portfolios with any degree of accuracy, they cannot know whether the current premiums and the earnings thereon will be sufficient to pay future claims. By allowing pension funds to match their assets and liabilities, the project will benefit not just pension funds but also the millions of employees who someday will depend on the funds for financial support.

Indonesia has three types of insurance companies -- life, social and indemnity -- and reinsurance companies. Of the total 108 insurance companies, 77 provide indemnity insurance, 23 provide life insurance, five provide social insurance and three are reinsurance companies. In 1985 over 2.7 million individuals, or 1.7% of the population, held life insurance policies, a figure which had been increasing at the rate of approximately 5% per year for the previous seven years. If this growth rate has continued until the present, the total would now exceed 3.1 million. At the same time the largest social insurance company, P.T. Astek, had over 2 million participants. Although the number of its policy holders is not known, P.T. A.K. Jasa Raharja, the largest indemnity insurer, has witnessed a growth of its assets exceeding 50% per year during the 1980s.

As with pension funds, insurance companies are predominantly invested in short-term time deposits. Life insurance companies, for example, maintain 55% of their investments in time deposits. As with pension funds, the project will benefit insurance companies and their policyholders by allowing the structuring of financially sound investment portfolios. (Additional data on pension and insurance fund's investments can be found in Annex E.)

7.1.3 Secondary Beneficiaries

The increase in activity on the part of the users and providers of funds will necessarily benefit the intermediary institutions in the financial markets. This includes money market participants such as banks and NBFIs, and capital market participants such as securities underwriters, brokers and dealers. All of these institutions will benefit from an increase in business and the development of professional skills. They will also benefit by being able to decrease their exposure to interest rate and default risk by diversifying portfolios and matching assets and liabilities.

As activity in the financial markets increases, so will competition. Increased competition will tend to lower the fees charged by these financial intermediaries. Studies in other countries, such as with the OTC market in the U.S., have indicated that profits of the intermediaries rise nonetheless. The increase in business more than compensates for the decrease in the size of individual fees. Furthermore, as the cost of intermediation is reduced, all other things being equal, investors will realize higher returns and the cost of funds will decrease. As a result, all parties involved in the financial system, whether big or small, users of funds, providers of funds or intermediaries, should benefit.

7.2 COST BENEFIT ANALYSIS

This cost benefit analysis is predicated on the assumption that the project will result in the seven End of Project Status (EOPS) as set forth in Table 2 (Section 3.5). The reader should be cautioned, however, that although the costs of the project are known, the benefits cannot easily be calculated. The problem is not that the outcomes are not quantifiable. The funds that will be raised through the public reissuance of stocks and bonds, for example, can be predicted with some decree of accuracy. However, quantifying the economic and social benefits which result is much more difficult. For instance, if the users of these funds invest in new plant and equipment, the return on this investment in terms of income and employment generation is difficult to estimate in advance. If a provider of these funds is able to structure a prudent and financially sound pension portfolio, it is likewise difficult to predict the extent to which future pensioners will benefit. Given the difficulties of quantifying end-user benefits of such a macro-scale project, the following cost benefit analysis examines direct economic benefits only, based on very conservative assumptions.

The first EOPS refers to the existence of an environment where the capital market is regulated and operated by separate authorities. The existence of such an environment undoubtedly would benefit the capital market, but quantifying this benefit would be impossible. This EOPS, therefore, is not included in the cost-benefit analysis. Likewise, the fifth EOPS regarding an automated check clearing system, and the seventh EOPS referring to changes in the Danareksa portfolio, are important, but unquantifiable in terms of benefits, and have not been included in the analysis.

The second EOPS states that at least five private brokerage firms will be able to operate profitably. Currently, maybe one of the approximately 20 private brokerage firms is profitable solely as a result of its capital market business. The other firms have other sources of income or are subsidiaries of large diversified companies, and view the capital market as a minor activity. Assuming that every year an already existing brokerage firm begins to earn enough solely from the capital market to operate profitably, it would not be unreasonable to expect that this firm would grow by three employees per year multiplied by Rp. 18 million per job per year resulting in total wages of Rp. 54 million per year over six years.

The third EOPS refers to the expected level of securities issuance and trading on the capital market. By the end of the sixth year, one new stock and two bond issues will be issued each month, average stock trading volume will reach 50,000 shares per day, and the total value of the securities listed on the capital market will reach Rp. 5 trillion. We assume that the issuance of new securities occurs gradually over the life of the project and that the value of the new issues equals the current average value of Rp. 7 billion for stocks and Rp. 45 billion for bonds. The result, therefore, would be 42 new issues of stock and 84 new issues of bonds by the end of the sixth year, with a total market value (including securities already issued) of Rp. 4.1 trillion. We further assume that the project is responsible for 1% of this increase.

The fourth EOPS refers to the existence of trading in commodity futures contracts. Such trading does not currently occur so it is extremely difficult to predict the value of the trading that the project will occasion. Since it is widely assumed that if futures trading is to begin it will be focused on rubber, we will concern ourselves with rubber only. Indonesia produced approximately Rp. 1.7 trillion tons of rubber last year. If just 0.5% of this production were hedged through the trading of futures contracts, that would represent the trading of contracts valued at Rp. 8.5 billion per year.

The sixth EOPS concerns an increase to Rp. 3 trillion in institutional participation in the capital market. Since this investment will be possible because of the increased issuance of securities, such benefits are already reflected in the third EOPS.

Table 9 calculates a positive net present value of the costs and benefits of the project of almost Rp. 35 billion ($ 21 million) using a discount rate of 25%. The 25% discount rate was used because it approximates the yield expected from relatively safe rupiah investments. It is important to remember that many of the project's benefits are impossible to quantify and are not included in this calculation and that those that are included were conservatively calculated. Furthermore, although the costs stop after six years, the benefits will continue long into the future and no attempt was made to include this certainly substantial value in the analysis. Nevertheless, the project still produces a large, positive net present value.

TABLE 9: CALCULATION OF THE NET PRESENT VALUE OF THE FINANCIAL MARKETS PROJECT

(Rp. Millions)

YEAR	TOTAL COST	BENEFITS 1/ EOPS 2	EOPS 3	EOPS 4	TOTAL	NET BENEFITS
1989	(1,270)	54	1,940	8,500	10,494	9,142
1990	(2,620)	54	3,880	8,500	12,434	10,237
1991	(2,870)	54	5,820	8,500	14,374	11,839
1992	(2,870)	54	7,760	8,500	16,314	13,272
1993	(2,790)	54	9,700	8,500	18,254	15,212
1994	(2,790)	54	11,640	8,500	20,194	17,152
TOTAL	(15,210)	324	40,740	51,000	92,064	76,854

NPV @ 25% = 34,686

1/ Annual stock and bond benefits (EOPS 3) are based on the following:

YEAR	#STOCKS ISSUED	STOCK VALUE	TOTAL	#BONDS ISSUED	BOND VALUE	TOTAL	TOTAL STOCKS AND BONDS	PERCENT ATTRB	TOTAL ATTRB
1989	2	7,000	14,000	4	45,000	180,000	194,000	0.01	1,940
1990	4	7,000	28,000	8	45,000	360,000	388,000	0.01	3,880
1991	6	7,000	42,000	12	45,000	540,000	582,000	0.01	5,820
1992	8	7,000	56,000	16	45,000	720,000	776,000	0.01	7,760
1993	10	7,000	70,000	20	45,000	900,000	970,000	0.01	9,700
1994	12	7,000	84,000	24	45,000	1,080,000	1,164,000	0.01	11,640
TOTAL	42		294,000	84		3,780,000	4,074,000		40,740

7.3 SOCIAL SOUNDNESS ANALYSIS

In attempting to analyze the social implications of the project, it must be kept in mind that the interventions planned are at the macroeconomic level and, therefore, are not easily attributable to individuals or even specific groups within the Indonesian economy or society. While it is thus anticipated that benefits from the development of Indonesia's financial markets will accrue in some manner to all segments of the economy, not all segments of the economy will benefit in the same way, within the same time frame, or even equally.

7.3.1 Targetted and Non-Targetted Groups

Individuals and groups specifically targetted by the project are those in a position to benefit directly from an increase in the number of debt and equity securities and commodity contracts, i.e., those with money to invest or those seeking long-term capital. This will include those already participating in a substantial way in the financial sector. However, it is important to note that this group will be broadened as a result of project interventions, since an expanded capital market will encourage much greater participation (in terms of both savings and borrowings) than in the past, when those with modest assets would have been ruled out as players in an environment which demanded substantially greater collateral than they could produce.

The following are examples of project beneficiaries. It is anticipated that manufacturing is one sector which will benefit significantly from the interventions of this project. Large-scale manufacturing firms may already have the wherewithal to access large amounts of capital, even under current conditions. As noted in Section 7.1, however, this project should prove especially beneficial to small to medium size firms which will enjoy greater access to capital and, as a result, will be able to expand and increase profits and employment. The small landholders who grow rubber, coffee and, perhaps palm oil and copra -- along with the processors themselves -- also stand to benefit when futures contracts for these commodities are traded on the ICE, as planned during the life of the project. Institutional investors, e.g., pension funds and insurance companies, will benefit from an environment which allows them to better match their assets (investments) with their liabilities. Better managed pension funds and insurance companies will result in benefits being passed on to those individuals covered by the pension plans and insurance policies. Individual investors will also benefit since Danareksa will sell securities to a much broader audience.

Groups not specifically targetted by the project are those which, even in a greatly strengthened economic environment, will not — at least during the life of this project — be in a position to benefit directly from an increase in the number of debt and equity securities and commodity contracts. Nonetheless, such individuals and groups of individuals, e.g., small farmers in non-estate crops, lower-level wage earners in the informal sector, and the chronically unemployed or underemployed, do stand to benefit indirectly from an improved economic environment, a more secure financial system, and increased job opportunities.

7.3.2 Impact on Income Distribution

The project will have a positive impact in the short and long terms on incomes within the targetted group. Non-targetted groups will likewise benefit from increased incomes, but only in the longer term as the impact of expanded financial markets is felt throughout the economy. Since the vast majority of the non-targetted groups are not involved in or dependent upon the formal financial sector, we anticipate no negative impact on their current income status. The impact of financial markets changes will, however, greatly increase the total level of savings and investment rather than skew current resources away from non-participants.

7.3.3 Impact on Employment

Employment opportunities throughout the economy are expected to increase as a result of the project. However, while long-term benefits of employment generation through the creation of a more open-market system are the strongest argument for this project, the short-term initial employment gains in the private sector may be somewhat offset by reduced employment levels in SOEs. This will depend on the GOI's proposed rate of SOE deregulation and the nature of any firms to be deregulated. The GOI approach to any SOE deregulation would include specific analysis of the means by which any negative employment impact can be minimized or compensated for, e.g., through retraining and placement efforts.

7.3.4 Impact on Women

In Indonesia, as in many other developing countries, part of the problem in women's access to credit is the unsatisfactory performance of financial markets as a whole -- a situation which this project will attempt to alleviate. Beyond that, specific constraints to formal credit which have been found worldwide to be particularly limiting to women include:

-- Limited financial resources are more likely to be directed to men since they are apt to hold economic control.

-- Concessional interest rate policies (credit programs) and large transaction costs for servicing small or new borrowers may discourage lending to women because they are often both new and relatively small borrowers.

-- Due to sex segregation in labor markets and occupation structures, women are more likely than men to lack profitable investment opportunities. In some cases, women may be unfamiliar with the concept of borrowing money in the formal sector, since credit programs tend to be publicized through men's networks.

-- Social restrictions on negotiating and lost work time in applying for loans in the formal sector result in higher transaction "costs" for women.

-- Collateral requirements may be impossible to satisfy when they are in the form of a house, land or other property.

-- Formal credit institutions may not have programs which are responsive to the types of work done or business run by women and which would allow, for example, loans to be paid back through multiple small deposits.

-- Social customs may restrict women's participation in modern credit systems.[1]

These are generic constraints which have been found to constrict full female participation in economies. To the extent these apply largely to women involved in very small or cottage industries, this project will have only an indirect impact. That is, as the economy responds favorably to expanded capital markets, women at the lower end will, presumably, benefit proportionately. This is particularly true in terms of employment opportunities. On the other hand, in the financial sector Indonesian women already enjoy relatively good access to jobs, at least in entry level positions, e.g., as accountants, bookkeepers, tellers, and financial analysts. As the financial sector grows, therefore, so too will the number of job opportunities for women seeking managerial positions.

Women entrepreneurs are, of course, a part of the targetted group. However, women in the formal business sector (not including cottage industries) number only about 10,000. Of these businesswomen, approximately 80% are in small business, and 20% are in medium and large business. An expanded capital market should allow women's participation in business to grow as access to credit becomes easier, and should provide significant opportunities for business expansion for those women already in business. Virtually all of these 10,000 Indonesian businesswomen are members of the Indonesian Business Women's Association (IWAPI), and the project will enlist the involvement of IWAPI in heightening awareness among businesswomen of improved opportunities for accessing capital. Such promotional efforts with IWAPI should help significantly in addressing some of the constraints noted above to women's participation in formal borrowing systems.

7.4 OTHER ECONOMIC CONSIDERATIONS

The rupiah is a convertible currency, there are no capital controls in Indonesia, and the GOI is current on its official debt service. Yet the maintenance of this record has not been without considerable cost. Public debt is both a large and politically sensitive issue in Indonesia -- large simply because of the debt service's share of the government budget, and politically sensitive because accommodating the increase in debt service payments has been at the expense of current government operations and has resulted in deep cuts in the development budget.

The FY 88/89 development budget is projected to be less than half its nominal level of FY 85/86. The operating budget decreased in nominal terms in

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1 Schumacher, Ilsa et al., Limits to Productivity: Improving Women's Access to Technology and Credit, Agency for International Development, Bureau of Program and Policy Coordination, under Contract Number AID/OTR-C-1801, May 1980.

each of the past two years; in real terms it will be about 12% less in FY 88/89 than it was in FY 85/86. Over the same period, the nominal amount allocated for debt service has tripled and its proportion of the operating budget has increased from 28% to 53%.

The Indonesian constitution requires that the GOI budget be "balanced," i.e., that there be no domestic borrowing. Hence all GOI debt, which is incurred to finance the government's operation or development budget, is foreign debt. Furthermore, official external debt management policy does not permit the government or state enterprises to engage in short-term borrowing. Therefore, all external public sector debt is medium- or long-term.

According to the Institute of International Finance (IIF), total public sector debt totaled almost $31.5 billion and total private sector debt almost $13.8 billion at the end of 1987. American, European and Japanese commercial bankers believe there is almost no risk associated with hard currency lending to the private sector in Indonesia. Their clients are, by and large, quite affluent local businessmen who have more on deposit offshore than they are borrowing for use in Indonesia. Therefore, little or no risk is involved as the loans are, in the eyes of the bankers, fully secured with offshore deposits.

7.4.1 External Debt

The IIF estimates that total external debt rose to more than $52 billion by the end of 1987, as compared with almost $43 billion at the end of 1986. The IIF estimates that 30% of the debt is denominated in yen and, of the aforementioned increase in external debt, $6.1 billion or 67% is due to the appreciation of the yen.

A breakdown of external debt by type is not a matter of public record, although the GOI is currently developing these data. Table 10 illustrates the IIF's estimate of the debt structure.

In 1988, external official debt service is expected to total $6.9 billion, or 35% of projected exports, as shown in Table 11. Public debt service (including state enterprises) is expected to total $7.2 billion or 37% of projected exports.

The estimates are that the amount of debt service will peak in 1989. If exports grow in line with the current forecast of 11%, the debt service ratio should peak this year and start to drop in 1989. At present this seems a reasonable assumption as all indications are that the outturn for export growth for the fiscal year just ended (March 31, 1988) is even higher than the January 1988 estimate of 28%.

Despite the economic costs and the political pressure to "do something about debt servicing costs," the GOI is firmly committed to maintaining a convertible currency, avoiding capital controls and keeping current on its external debt service. Numerous statements by the President and cabinet ministries underline the GOI's commitment to these three goals. Furthermore, the President has refused to entertain suggestions for a debt rescheduling. He believes a rescheduling would impair Indonesian access to external credit markets, thus further complicating Indonesian economic development (by increasing the cost of or drying up the GOI's ability to borrow). Instead,

TABLE 10: IIF ESTIMATES OF TOTAL DISBURSED INDONESIAN EXTERNAL DEBT

($ millions)

	1985	1986	1987	1988
Total Official Debt	29,539	33,034	38,492	39,802
A. Total from Official Sources	21,179	25,377	31,472	32,792
Multilateral	5,307	7,027	9,690	10,459
Bilateral (1)	15,872	18,350	21,782	22,333
Nationalization	-	-	n/a	n/a
LNG Expansion	-	-	n/a	n/a
B. Total Private Sources of Which:	8,360	7,656	7,020	7,010
Commercial	5,687	4,232	n/a	n/a
Total Pvt. Sector Debt	7,723	10,721	13,750	13,397
A. Medium/Long Term	2,589	5,450	8,517	7,947
B. Short Term	5,134	5,271	5,134	5,271
Total Debt	37,525	43,755	52,242	53,199

Notes:

(1) Includes bilateral, bonds, nationalization, and LNG expansion.
— Source: IIF - March 2, 1988 Report.

TABLE 11: PUBLIC SECTOR EXTERNAL DEBT SERVICE REQUIREMENTS

($ millions)

	Govern't Direct Debt			Debt of State Corp.		
	Amort	Int	Total	Amort	Int	Total
1986	2,576	2,152	4,726	244	104	348
1987	3,425	2,313	5,738	225	96	321
1988	4,325	2,565	6,890	241	82	323
1989	4,579	2,675	7,254	230	60	290
1990	4,409	2,668	7,077	190	47	237
1991	4,526	2,614	7,140	119	23	142

Notes:
— amort - amortization; int - interest.
-- Sources: based on data from Bank Indonesia, Kuhn Leob memorandums and Embassy estimates.

Indonesia will continue its efforts to restructure without resorting to an IMF program or the Paris Club. Indonesia is hoping for new and large assistance from Japan and for a new approach to handling the appreciation of the yen. Without such assistance, Indonesia's ability to stay current on external balances easily could be placed in jeopardy. A large fall in oil prices, a major recession in OECD countries that limits or reverses non-oil export growth, and a number of other possibilities could upset the fragile balance that barely permits the GOI to provide the services domestic audiences expect while continuing to remain current on external debt. The real question is the out years. Will non-oil exports grow by enough to cover the rising debt service and growth in imports necessary to keep the economy growing?

7.4.2 Domestic Debt

At the end of 1987, domestic bank credit amounted to Rp. 28 trillion, which represented an increase of 24% from 1986. This increase was the highest since the monetary reforms in 1983 and is indicative of the recent improvement in the environment for domestic investment. Deposit money banks extended the largest amount of credits, Rp. 27 trillion, state banks extended Rp. 19 trillion, private national commercial banks extended Rp. 6 trillion, foreign banks extended Rp. 1.2 trillion, and regional development banks extended Rp. 786 billion.

Direct Bank Indonesia credits, primarily to the two state savings banks, totalled Rp. 1.2 trillion and were extended mainly to encourage mortgage lending to the lower income groups. During this same period, bank credits to all sectors of the economy rose substantially. The manufacturing sector received the highest level of credits (Rp. 1.9 trillion), representing a 25% increase from the previous year, directed primarily at chemicals, plastics, textiles, paper and wood products. Credits to the trade sector for purchasing domestically traded goods and for exporting finished and semi-finished goods increased by 19% to Rp. 1.3 trillion. The service sector received Rp. 490 billion, an increase of 13%, to finance low-cost housing, businesses, electricity and public transportation. Credits to the agricultural sector increased by 20% to Rp. 372 billion in order to finance rubber, oil palm, sugar cane and tobacco plantations. The mining sector registered the largest increase, 53% percent, to Rp. 136 billion, to finance oil, gas and coal mines.

7.4.3 Potential Economic Impacts

The project's primary impact on the debt position of the GOI, as a result of increasing the private sector's access to finance, should be to speed the transfer of debt from the public sector to the private sector. As the funds flowing to the private sector increase, the public sector will be able to decrease that part of its borrowing, both foreign and domestic, which is used to support the private sector. Since public sector borrowing is necessarily foreign debt, the GOI should be able to decrease its additional foreign borrowings below what would have been necessary in the absence of the project.

The project will increase the availability of domestic equity finance. As the private sector increases its use of such finance, the need for additional foreign or domestic debt finance will decrease. As a result, both the public and private sectors will be able to decrease further their reliance on debt finance and the high degree of leverage in the economy will decrease.

The development of the local financial markets will increase the efficiency of the flow of funds between savings and investment and will stimulate additional savings and investment. This also will allow the GOI to reduce its reliance on foreign borrowings. Furthermore, increased financial market activity also will attract foreign capital to Indonesia. Instead of borrowing foreign funds offshore, those same funds will become available domestically. The net effect of the project, therefore, will be to improve the foreign debt position of both the public and private sectors in Indonesia.

The project will improve the ability of the GOI to monitor the economy. By increasing the level of financial disclosure and bringing into the formal sector financial activities which currently are carried out informally, the project will provide Bank Indonesia with additional information regarding, and new tools to help implement, fiscal and monetary policy. As a result, Bank Indonesia will be better able to control annual inflation which is between 8-9%. While this level is not onerous, it is high relative to almost all other Southeast Asian nations. At a recent conference on the capital market held in Jakarta, a prominent Indonesian economist stated that to ensure economic development sufficient to satisfy Indonesia's growing population "domestic inflation should be controlled to under 5% per annum." If this level is not achieved and domestic inflation remains higher than inflation in countries competing with Indonesia in international markets, he then predicted that the rupiah exchange rate will have to be continuously adjusted downward. This requires either that the rupiah float freely or that the rupiah be devalued periodically, as has happened twice in the last four years. The suddenness and scale of these past devaluations have proved to be traumatic. The related cost and price adjustments stimulate further domestic inflation, especially for manufacturing processes which utilize imported components. Domestic purchasing power, however, remains weak. Joint ventures suffer severe loses and are dissuaded from expanding, and potential new joint ventures may decide to locate in other countries. By increasing Bank Indonesia's monitoring capability, the project will reduce inflationary pressure, decrease the need for future devaluations and brighten the outlook for domestic foreign investment.

The fear of additional devaluations also is one of the reasons domestic interest rates, both in nominal and real terms, are the highest in Southeast Asia. Such rates appear to be necessary for the banks to attract deposits. Unfortunately, such high rates also attract funds which might otherwise have been invested more productively in plants and capital equipment. By reducing inflationary pressures and decreasing the cost of intermediation by increasing the efficiency and competitiveness of the financial markets, interest rates should decline. Any decrease in interest rates should be reflected in a decrease in inflation and vice versa.

7.5 ENVIRONMENTAL ANALYSIS

An initial environmental review was performed when this project was at the Project Identification Document (PID) stage. As a result of that review, it was recommended and approved that the project be categorically excluded from further environmental review (see Annex G). The activities presently envisaged under the project are the same as those proposed at the PID stage. Therefore, the categorical exclusion remains in effect.

8. IMPLEMENTATION

8.1 ADMINISTRATIVE ANALYSIS

The Ministry of Finance, which is the proposed executing agency for this project, has the authority to determine Indonesia's capital market policy. In addition, it regulates the markets through BAPEPAM in coordination with Bank Indonesia. The Directorate General of Monetary Affairs will be the MOF implementing body. Within this Directorate General, the Directorate of Financial Institutions and Accountancy will be the day-to-day unit in charge of the project. USAID has a longstanding working relationship with this Directorate, having worked together especially closely in the last two years on capital market issues and the establishment of the Bursa Paralel. In addition to this Directorate's present staff of over 130 professionals, it is anticipated that three counterpart professionals will be assigned to the staff. These three staff members will each work on a day-to-day basis with the project team so that the MOF gains the full benefit of the team's experience.

From our substantial past experience, we conclude that the MOF implementing structure and staff are fully capable of successfully executing this project. Although task-specific short-term training is envisaged for MOF personnel to develop specific capital market skills, no general training is proposed or required.

The primary counterpart to the Bank Indonesia contract will be the Governor of Bank Indonesia and the Managing Director for Credit. USAID also has a good long-term working relationship with Bank Indonesia through an ongoing PASA with the Federal Reserve Board. Much of this project's work will be a continuation of current efforts.

Coordination between Bank Indonesia and the Ministry of Finance will be accomplished both directly and through the Capital Markets Policy Council. This council consists of the Minister of Finance, the Vice Chairman of BAPPENAS (the National Development Planning Board), the Minister of Trade, Secretary of the Cabinet, the Governor of Bank Indonesia, the Chairman of BKPM, the Minister of Industry and the Minister of the State Secretary. The main task of this Council is to present policy alternatives to the Minister of Finance regarding the capital market and Danareksa. This Council also has a working group comprised of Director General-level officials from the various ministries and agencies which handle most of the day-to-day policy implementation. This Council will be especially important for dealing with inter-ministerial matters under this project, such as the ICE which falls under the Ministry of Trade's jurisdiction, and investment policies which are under various agencies including BKPM.

Danareksa, PPUE and the pension funds and insurance companies are all regulated by and report to the Director General of Monetary Affairs, MOF. Thus, the five-person MOF team will work through the MOF as its contact for the various parties working in the capital market. The MOF consulting team will be physically located in the Danareksa Building, which houses some MOF staff, the stock exchange, Danareksa, BAPEPAM and other capital market groups. USAID and Bank Indonesia are only one block away. Project coordination will be greatly assisted by the proximity of all parties involved.

Within USAID, the project will be administered by the Office of Private Sector Development (PSD), wherein the Project Officer assignment will reside. The PSD Office has developed considerable expertise in the finance sector through the Financial Institutions Development and the Private Sector Development Projects. In addition, this office has strong links with the PRE Bureau in AID/W. PRE will be the source of significant assistance on the project through its own Financial Markets Project II which is just starting. PRE also has developed a considerable number of contacts in the U.S. capital market which serve as a potential source of expertise on issues such as deregulation, portfolio management and regulatory reform. The PSD Project Officer will be assisted by a Project Implementation Committee, including PPS, EPSO, FMP and LO. We conclude that the PSD Office, as assisted by this Committee and the PRE Bureau, is fully able to meet its technical and administrative responsibilities under the proposed project.

8.2 CONTRACTING PLAN

As noted earlier, the bulk of all project implementation and delivery of inputs will be handled through two umbrella contracts--one with MOF and one with Bank Indonesia. A description of each of these contracts and contracting procedures follows.

8.2.1 MOF Contract

This five-year contract will provide a team consisting of six long-term advisors plus up to 30 person-months of short-term assistance. The short-term portion will be augmented by a 50% contribution for buy-ins with the PRE Bureau Financial Markets Project for an additional 30 person-months. (This 50% buy-in was listed earlier as 15 person-months for budget estimate purposes.) This contract will also include funding for the promotions subcontractor; for all MOF sponsored short-term training, estimated at 100 person-months; for the PPUE and ICE computer systems, promotional commodities and campaign expenses; and commodity support for the consultants.

Subject to a USAID review of GOI contracting procedures, this will be a Ministry of Finance host country contract (HCC) action in accordance with A.I.D. Handbook 11. Contracting will be done through full and open competition with advertisements in the U.S. and Indonesia. A prequalification exercise will determine the short list of eligible, qualified firms, to be limited to U.S., Indonesian, or joint U.S.-Indonesian firms. The selection process will be based on technical factors first, the highest ranked firm being selected for negotiations. MOF and USAID will jointly evaluate technical proposals.

Given the Ministry of Finance's considerable prior experience in contracting with expatriate organizations, such as the Harvard Institute for International Development, we believe MOF has gained all requisite contracting skills to administer such a contract successfully. The HCC mode will also strengthen the working relationship of the MOF and consultants.

All training and promotional commodity funding under the MOF contract, except for the promotions subcontractor, shall be included under the contract as a flow-through only. Thus, there will be no overhead or fee on these items. The procurement for promotional campaigns shall be done by the promotions subcontractor. All other procurement of commodities under this contract shall be solicited competitively by the contractor in accordance with A.I.D. Handbook 11 procedures. The source-origin of all commodities, except for local shelf procurements, will be Code 000--the U.S. or Indonesia.

It is anticipated that this contract will be initially advertised in October 1988 and will be executed in approximately June 1989. The five-year contract would then extend until June 1994, three months prior to the PACD of 30 September 1994. See Annex D for the MOF Scope of Work.

8.2.2 Bank Indonesia Contract

The five-year Bank Indonesia contract will consist of one long-term expert plus up to 60 person-months of short-term assistance. As with the MOF contract, 30 person-months of the short-term assistance will consist of 50% buy-ins to the PRE Bureau Financial Markets Project. Thus, 45 person-months are budgeted under project funding. In addition, this contract will include funding for up to 50 months of Bank Indonesia short-term training and consultant commodity support.

As in the case of the MOF contract, subject to a USAID review of GOI contracting procedures, the HCC contracting mode will also be employed for this contract with Bank Indonesia as the contracting agency. However, given the smaller size of this contract, there will not be a need for a prequalification stage. Advertisements in the U.S. and Indonesia will be placed, with the competitive bid process again being open to U.S., Indonesian or joint U.S.-Indonesian firms. The contracting process will otherwise be identical to that for the MOF contract. Bank Indonesia, having been responsible for reviewing all expatriate contracts for the GOI for several years and also having several expatriate contractors already on board, is fully capable to administer the contract. This contract should also be advertised in October 1988 and executed in about June 1989, extending for five years. The Scope of Work for this contract is set forth in Annex D.

8.2.3 Other Contracts

The only other anticipated contracting or commitment actions are for evaluations or audits. The evaluations will be performed under A.I.D. indirect contracting procedures, most likely with an IQC work order. Any audits would be charged directly through a Project Implementation Letter (PIL), most likely using the services of a local IQC contract through the USAID Office of Financial Management.

8.2.4 Gray Amendment Contracting

While the prime contractor or consultant is not likely to be an 8A or Gray Amendment entity for either contract given the specialized nature of the work, there are several possible candidate 8A firms who might qualify as a partner for recruiting short-term experts. Given the broad nature of the two contracts, it is unlikely that any one firm could fill all the required positions from within.

8.3 MONITORING, EVALUATION AND AUDIT

8.3.1 Monitoring and Evaluation Plan

Given the relatively quantifiable nature of this project, it is expected that the monitoring and evaluation processes will be very closely associated. This can be done by establishing monitoring and evaluation benchmarks related directly to the EOPS and other financial and economic statistics. In consultation with the Project Committee, the Office of Private Sector Development will establish evaluation benchmarks which will then be approved by the USAID Director in early FY 1989. At approximately the same time, an implementation seminar will be held to agree upon basic implementation issues (to include a system for project impact tracking) among relevant project parties, e.g., MOF, PPUE, Bapepam, Danareksa.

The proposed method for project monitoring would be to include the data collection tasks in the quarterly reporting requirements for each of the two consulting teams. The trade and finance macroeconomist, who will begin work in the USAID Economic and Policy Support Office (EPSO) in November, would assist the PSD Office in designing this monitoring and evaluation system. This system can be integrated into cash flow analyses performed by the GOI and World Bank to better assess trends in long-term capital formation.

Monitoring the contractors' performance would be the responsibility of the PSD Project Officer. This would be done in concert with the Ministry of Finance and Bank Indonesia. The Project Officer would also assist in the early stages of project implementation to ensure that the contractors establish appropriate procedures for short-term training, procurement, PRE Bureau buy-ins and promotional campaigns. Each of these components would then require a periodic reporting system to enable the Project Officer to monitor progress and compliance with the contract and A.I.D. regulations.

With respect to formal evaluation, the establishment of a quarterly monitoring system should alleviate the need for large-scale review. It is anticipated that a two-person team could perform one-month evaluations at the end of the second, fourth and sixth years. The second year evaluation would focus on both ensuring that the delivery systems for outputs are in place and that progress on regulatory reform has been achieved. The second and final evaluations would examine overall progress.

8.3.2 Audit Procedures

Project assistance financed by A.I.D. and the GOI is subject to audit by A.I.D. In order to minimize vulnerability, the Mission Controller will conduct periodic examinations of records, and as part of its voucher examination program, will review GOI accounting procedures and documentation relating to their direct procurement financed under the project. Project funding is also available for project audit, including host country and A.I.D. direct contracts, following guidelines from the A.I.D. Inspector General's Office. This audit coverage will be performed by auditors through local representatives of U.S. certified public accountant firms, with assistance from the A.I.D. Regional Inspector General - Audit Division in Manila. These services will be procured with project funds by A.I.D. direct contract following direct payment procedures. In addition, A.I.D. may utilize project funding to obtain financial management technical assistance to assess, and where necessary, assist in upgrading the financial management system of project units.

8.4 IMPLEMENTATION SCHEDULE

The following schedule sets forth the major project milestones, the target date for achieving each milestone, and the primary party responsible for actions leading up to each milestone.

Milestone	Target Date	Responsibility
Bilateral Obligation of Project	August 1988	BAPPENAS, MOF, USAID
Advertise MOF Contract	October 1988	MOF, USAID
Advertise BI Contract	October 1988	BI, USAID
Project Implementation Seminar	Early FY 1989	MOF, USAID
Establish MOF/BI Training Committee	November 1988	MOF, BI, OTO*, USAID
Prequalify MOF Contractors	January 1989	MOF, USAID
Evaluate BI Proposals	February 1989	BI, USAID
Establish USAID Monitoring Format	March 1989	USAID, MOF, BI
Select MOF Contract Final Proposals	April 1989	MOF, USAID
Select BI Contractor	April 1989	BI, USAID
Project Amendment-Deregulation Fund	April 1989	USAID, MOF
Negotiate/Execute MOF Contract	June 1989	MOF
Negotiate/Execute BI Contract	June 1989	BI
BI/MOF Workplans Submitted	Sept. 1989	Contractors
First Baseline Monitoring Report	Sept. 1989	Contractors
Initial Short-term Training	October 1989	Contractors, MOF
Initial Promotion Campaign	January 1990	Contractors, MOF
First Evaluation	Sept. 1990	USAID, MOF, BI
Market Deregulation Completed	June 1991	MOF
Second Evaluation	Sept. 1992	USAID, MOF, BI
Final Evaluation	Sept. 1994	USAID, MOF, BI

8.5 CONDITIONS PRECEDENT AND COVENANTS

8.5.1 Conditions Precedent

The following condition precedent is proposed for the Financial Markets Project Grant Agreement:

> Prior to the commitment of any funds by A.I.D. for technical assistance, the MOF and Bank Indonesia will have appointed three-person and one-person full-time counterpart teams, respectively. These counterparts will work exclusively with the consulting teams on tasks related to this project.

In addition, there will be standard conditions precedent and covenants, including GOI designation of authorized signatories.

* Overseas Training Office, BAPPENAS

8.5.2 Covenants

The following special covenants are proposed for the Financial Markets Project Grant Agreement:

(1) The GOI and A.I.D. will agree to establish an evaluation program as part of the Project. The program will include, during the implementation of the Project: (a) collection of initial baseline data with reference to interim and final project objectives; (b) evaluation of progress toward attainment of the interim and final Project objectives after the second, fourth and sixth years of the Project; (c) identification and evaluation of problem areas or constraints which may inhibit such attainment; (d) assessment of how such information may be used to help overcome such problems; and (e) evaluation, to the degree feasible, of the overall development impact of the Project.

(2) The GOI will agree to develop a yearly detailed implementation and training plan for the Project which will describe the sequence of activities to be undertaken and persons to be trained in each fiscal year. The implementation and training plan for each year will be submitted to A.I.D. for review and approval prior to the start of the year covered by the plan.

(3) The GOI will covenant to supply sufficient funds to maintain and supply equipment furnished under the Project.

ANNEX A

5C(2) - PROJECT CHECKLIST

Listed below are statutory criteria applicable to projects. This section is divided into two parts. Part A includes criteria applicable to all projects. Part B applies to projects funded from specific sources only: B(1) applies to all projects funded with Development Assistance; B(2) applies to projects funded from Development Assistance loans; and B(3) applies to projects funded from ESF.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED FOR THIS PROJECT?	Yes.

A. GENERAL CRITERIA FOR PROJECT

1. FY 1988 Continuing Resolution Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.	A Congressional Notification was prepared and the Congressional notification period expired without objection on August 17, 1988.
2. FAA Sec. 611(a)(1). Prior to obligation in excess of $500,000, will there be (a) engineering, financial or other plans necessary to carry out the assistance and (b) a reasonably firm estimate of the cost to the U.S. of the assistance?	(a) Yes. (b) Yes.
3. FAA Sec. 611(a)(2). If legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?	No further legislative action is required.
4. FAA Sec. 611(b); FY 1988 Continuing Resolution Sec. 5[illegible]. If project is for water or water-related land resource construction, have benefits and costs been computed to the extent practicable in accordance with the principles, standards, and procedures established pursuant to the Water Resources Planning Act (42 U.S.C. 1962, et sec.)? (See AID Handbook 3 for guidelines.)	N/A.

5. FAA Sec. 611(e). If project is capital assistance (e.g., construction), and total U.S. assistance for it will exceed $1 million, has Mission Director certified and Regional Assistant Administrator taken into consideration the country's capability to maintain and utilize the project effectively?

N/A.

6. FAA Sec. 209. Is project susceptible to execution as part of regional or multilateral project? If so, why is project not so executed? Information and conclusion whether assistance will encourage regional development programs.

No.
N/A.

N/A.

7. FAA Sec. 601(a). Information and conclusions on whether projects will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; and (c) encourage development and use of cooperatives, and credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.

The further development of Indonesia's financial markets will have positive effects on a freer flow of (a) international trade as well as capital. An increased liberalization of these markets should also have a positive impact on (b), (c), (d) and (e).
(f) N/A.

8. FAA Sec. 601(b). Information and conclusions on how project will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

The project will finance long- and short-term technical assistance from the United States. It should also positively impact on future investment by U.S. firms.

9. FAA Sec. 612(b), 636(h); FY 1988 Continuing Resolution Sec. 509. Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.

The GOI and the Indonesian private sector will provide the equivalent of $3.0 million for the project, primarily for local costs.

10. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?

No.

11. FY 1988 Continuing Resolution Sec. 522. If assistance is for the production of any commodity for export, is the commodity

likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity? N/A.

12. FY 1988 Continuing Resolution Sec 552. (as interpreted by conference report). If assistance is for agricultural development activities (specifically, any testing or breeding feasibility study, variety improvement or introduction, consultancy, publication, conference, or training), are such activities (a) specifically and principally designed to increase agricultural exports by the host country to a country other than the United States, where the export would lead to direct competition in that third country with exports of a similar commodity grown or produced in the United States, and can the activities reasonably be expected to cause substantial injury to U.S. exporters of a similar agricultural commodity; or (b) in support of research that is intended primarily to benefit U.S. producers? N/A.

13. FY 1988 Continuing Resolution Sec. 553. Will the assistance (except for programs in Caribbean Basin Initiative countries under U.S. Tariff Schedule: Section 807," which allows reduced tariffs on articles assembled abroad from U.S.-made components) be used directly to procure feasibility studies, prefeasibility studies, or project profiles of potential investment in, or to assist the establishment of facilities specifically designed for, the manufacture for export to the United States or to third country markets in direct competition with U.S. exports, of textiles, apparel, footwear, handbags, flat goods (such as wallets of coin purses worn on the person), work gloves or leather wearing apparel? No.

14. FAA 118(c). Does the assistance comply with the environmental procedures set forth in A.I.D. Regulation 16? Does the assistance place a high priority on conservation and sustainable management of tropical forests? Specifically, does Yes. See Annex G.

the assistance, to the fullest extent feasible: (a) stress the importance of conserving and sustainably managing forest resources;	(a) N/A.
(b) support activities which offer employment and income alternatives to those who otherwise would cause destruction and loss of forests, and help countries identify and implement alternatives to colonizing forested areas;	(b) N/A.
(c) support training programs, educational efforts, and the establishment or strengthening of institutions to improve forest management;	(c) N/A.
(d) help end destructive slash-and-burn agriculture by supporting stable and productive farming practices;	(d) N/A.
(e) help conserve forests which have not yet been degraded, by helping to increase production on lands already cleared or degraded ;	(e) N/A.
(f) conserve forested watersheds and rehabilitate those which have been deforested;	(f) N/A.
(g) support training, research, and other actions which lead to sustainable and more environmentally sound practices for timber harvesting, removal, and processing;	(g) N/A.
(h) support research to expand knowledge of tropical forests and identify alternatives which will prevent forest destruction, loss, or degradation;	(h) N/A.
(i) conserve biological diversity in forest areas by supporting efforts to identify, establish, and maintain a representative network of protected tropical forest ecosystems on a worldwide basis, by making the establishment of protected areas a condition of support for activities involving forest clearance or degradation, and by helping to identify tropical forest ecosystems and species in need of protection and establish and maintain appropriate protected areas;	(i) N/A.
(j) seek to increase the awareness of U.S. government agencies and other donors of the immediate and long-term value of tropical forests;	(j) N/A.
and (k) utilize the resources and abilities of all relevant U.S. government agencies?	(k) N/A.

16. <u>FAA Sec. 119(g)(4)-(6).</u> Will the

assistance (a) support training and education efforts which improve the capacity of recipient countries to prevent loss of biological diversity;	(a) N/A.
(b) be	(b) N/A.

provided under long-term agreement in which the recipient country agrees to protect ecosystems or other wildlife habitats; (c) support efforts to identify and survey ecosystems in recipient countries worthy of protection; or (d) by any direct or indirect means significantly degrade national parks or similar protected areas or introduce exotic plants or animals into such areas?

(c) N/A.

(d) N/A.

17. FAA 121(d). If a Sahel project, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of project funds (either dollars or local currency generated therefrom)?

N/A.

B. FUNDING CRITERIA FOR PROJECT

1. Development Assistance Project Criteria

a. FAA Sec. 102(a), 111, 113, 281(a). Describe extent to which activity will (a) effectively involve the poor in development by extending access to economy at local level, increasing labor-intensive production and the use of appropriate technology, dispersing investment from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries?

(a) The poor will benefit from an an increase in employment opportunities generated by more efficient financial markets directing investment to the productive sector.

(b) N/A.

(c) N/A.

(d) N/A.

(e) N/A.

b. FAA Sec. 103, 103A, 104, 105, 106, 120-21. Does the project fit the criteria for the type of funds (functional account) being used?

The project fully meets the criteria for FAA Section 106.

c. FAA Sec. 107. Is emphasis placed on use of appropriate technology (relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)?

N/A.

d. FAA Sec. 110, 124(d). Will the recipient country provide at least 25 percent of the costs of the program, project, or activity with respect to which the assistance is to be furnished (or is the latter cost-sharing requirement being waived for a "relatively least developed" country)?

Yes.

e. FAA Sec. 128(b). If the activity attempts to increase the institutional capabilities of private organizations or the government of the country, or if it attempts to stimulate scientific and technological research, has it been designed and will it be monitored to ensure that the ultimate beneficiaries are the poor majority?

Yes.

f. FAA Sec. 281(b). Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civil education and training in skills required for effective participation in governmental processes essential to self-government.

The project is based on more than five years of analytical work in the financial markets arena, which explored options in assisting the GOI and the Indonesian private sector to achieve increased employment generation through improved functioning of financial markets; local capabilities will be used to the maximum extent possible.

g. FY 1988 Continuing Resolution Sec. 538. Are any of the funds to be used for the performance of abortions as a method of family planning or to motivate or coerce any person to practice abortions?

No.

Are any of the funds to be used to pay for the performance of involuntary sterilization as a method of family planning or to coerce or provide any financial incentive to any person to undergo sterilizations?

No.

Are any of the funds to be used to pay for any biomedical research which relates, in whole or in part, to methods of, or the performance of, abortions or involuntary sterilization as a means of family planning? No.

h. FY 1988 Continuing Resolution. Is the assistance being made available to any organization or program which has been determined to support or participate in the management of a program of coercive abortion or involuntary sterilization? No.

If assistance is from the population functional account, are any of the funds to be made available to voluntary family planning projects which do not offer, either directly or through referral to or information about access to, a broad range of family planning methods and services? N/A.

i. FAA Sec. 601(e). Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow others? Yes.

j. FY 1988 Continuing Resolution. How much of the funds will be available only for activities of economically and socially disadvantaged enterprises, historically black colleges and universities, and private and voluntary organizations which are controlled by individuals who are black Americans, Hispanic Americans, or Native Americans, or who are economically or socially disadvantaged (including women)?

Given the broad nature of the two technical assistance contracts to be awarded, it is unlikely that any one firm or organization could fill all of the required positions. There are, however, a number of 8A firms who might qualify as a partner for recruiting short-term experts for the project's needs.

k. FAA Sec. 118(c)(13). If the assistance will support a program or project significantly affecting tropical forests including projects involving the planting of exotic plan species), will the program or project (a) be based upon careful analysis of the alternatives available to achieve the best sustainable use of the land, and (b) take full account of the environmental impacts of the proposed activities on biological diversity? N/A.

l. FAA Sec. 118(c)(14). Will assistance be used for (a) the procurement or use of logging equipment, unless an environmental assessment indicates that all timber harvesting operations involved will be conducted in an environmentally sound N/A.

manner and that the proposed activity will produce positive economic benefits and sustainable forest management systems; or (b) actions which significantly degrade national parks or similar protected areas which contain tropical forests, or introduce exotic plants or animals into such areas?

m. FAA Sec. 118(c)(15). Will assistance be used for (a) activities which would result in the conversion of forest lands to the rearing of livestock; (b) the construction, upgrading, or maintenance or roads (including temporary haul roads for logging or other extractive industries) which pass through relatively undegraded forest lands; (c) the colonization of forest lands; or (d) the construction of dams or other water control structures which flood relatively undegraded forest lands, unless with respect to each such activity an environmental assessment indicates that the activity will contribute significantly and directly to improving the livelihood of the rural poor and will be conducted in an environmentally sound manner which supports sustainable development? — N/A.

2. Development Assistance Project Criteria (Loans Only)

a. FAA Sec. 122(b). Information and conclusion on capacity of the country to repay the loan, at a reasonable rate of interest. — N/A.

b. FAA Sec. 620(d). If assistance is for any productive enterprise which will compete with U.S. enterprises, is there an agreement by the recipient country to prevent export to the U.S. of more than 20 percent of the enterprise's annual production during the life of the loan, or has the requirement to enter into such an agreement been waived by the President because of a national security interest? — N/A.

c. FY 1988 Continuing Resolution. If for a loan to a private sector institution from funds made available to carry out the provisions of FAA Sections 103 through 106, will loan be provided, to the maximum extent practicable, at or near the prevailing interest rate paid on Treasury obligations of similar maturity at the time of obligating such funds? — N/A.

d. FAA Sec. 122(b). Does the activity give reasonable promise of assisting long-range plans and programs designed to develop economic resources and increase productive capacities? — N/A.

3. Economic Support Fund Project Criteria — This project is not ESF-funded.

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA? — N/A.

b. FAA Sec. 531(e). Will this assistance be used for military or paramilitary purposes? — N/A.

c. ISDCA of 1985 Sec. 207. Will ESF funds be used to finance the construction, operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such country is a party to the Treaty on the Non-Proliferation of Nuclear Weapons or the Treaty for the Prohibition of Nuclear Weapons in Latin America (the "Treaty of Tlatelolco"), cooperates fully with the IAEA, and pursues non-proliferation policies consistent with those of the United States? — N/A.

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? — N/A.

5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. PROCUREMENT

1. FAA Sec. 602(a). Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed? — Yes.

2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or under delegation from him? — Yes.

3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company? — Indonesia does not so discriminate against U.S. marine insurers.

4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If non-U.S. procurement of agricultural commodity or product thereof is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity (Exception where commodity financed could not reasonably be procured in U.S.). — N/A.

5. FAA Sec. 604(g). Will construction or engineering services be procured from firms of advanced developing countries which are otherwise eligible under Code 941 and which have attained a competitive capability in international markets in one of these areas? (Exception for those countries which receive direct economic assistance under the FAA and permit United States forms to compete for construction or engineering services financed from assistance programs of these countries.) — N/A.

6. FAA Sec. 603. Is the shipping excluded from compliance with the requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 percent of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates?

   No. Section 901(b) applies.

7. FAA Sec. 621(a). If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? will the facilities and resources of other Federal agencies be utilized, when they are particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?

   Yes.

8. International Air Transportation Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available?

   Yes.

9. FY 1988 Continuing Resolution Sec. 504. If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United States?

   All A.I.D. direct contracts will so provide.

10. FY 1988 Continuing Resolution Sec. 524. If assistance is for consulting service through procurement contract pursuant to 5 U.S.C. 3109, are contract expenditures a matter of public record and available for public inspection (unless otherwise provided by law or Executive order)?

    Yes. Any such expenditures will be so available.

B. CONSTRUCTION

1. FAA Sec. 601(d). If capital (e.g., construction) project, will U.S. engineering and professional services be used?

   N/A.

2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable?

   N/A.

3. FAA Sec. 620(k). If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP), or does assistance have the express approval of Congress?

   N/A.

OTHER RESTRICTIONS

1. FAA Sec. 122(b). If development loan repayable in dollars, is interest rate at least 2 percent per annum during a grace period which is not to exceed ten years, and at least 3 percent per annum thereafter?

   N/A.

2. FAA Sec. 301(d). If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights?

   N/A.

3. FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries?

   Yes.

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4. Will arrangements preclude use of financing:

a. FAA Sec. 104(f); FY 1988 Continuing Resolution Secs. 525, 538. (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; or (4) to lobby for abortion? — (1) Yes. (2) Yes. (3) Yes. (4) Yes.

b. FAA Sec. 483. To make reimbursements, in the form of cash payments, to persons whose illicit drug crops are eradicated? — Yes.

c. FAA Sec. 620(g). To compensate owners for expropriated or nationalized property, except to compensate foreign nationals in accordance with a land reform program certified by the President? — Yes.

d. FAA Sec. 660. To provide training advice, or any financial support for police, prisons, or other law enforcement forces, except for narcotics programs? — Yes.

e. FAA Sec. 662. For CIA activities? — Yes.

f. FAA Sec. 636(i). For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained? — Yes.

g. FY 1988 Continuing Resolution Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for military personnel? — Yes.

h. FY 1988 Continuing Resolution Sec. 505. To pay U.N. assessments, arrearages or dues? — Yes.

i. FY 1988 Continuing Resolution Sec. 506. To carry out provisions of FAA section 209(d) (transfer of FAA funds to multilateral organizations for lending)? — Yes.

j. FY 1988 Continuing Resolution Sec. 510. To finance the export of nuclear equipment, fuel, or technology? — Yes.

k. FY 1988 Continuing Resolution Sec. 511. For the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights? — Yes.

l. FY 1988 Continuing Resolution Sec. 516. To be used for publicity or propaganda purposes within U.S. not authorized by Congress? — Yes.

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ANNEX B

REPUBLIC OF INDONESIA
NATIONAL DEVELOPMENT PLANNING AGENCY
JAKARTA, INDONESIA

No. : 3385/K/8/1988 Jakarta, August 26, 1988

RECEIVED
AUG 26 1988
USAID/C&R
Jakarta

Mr. David N. Merrill
Director
Agency for International Development
American Embassy
JAKARTA

Re: Financial Markets Project

Dear Mr. Merrill,

The Government of Indonesia (GOI) hereby requests the assistance of the U.S. Agency for International Development (USAID) in the form of $. 9.0 million grant to finance the proposed Financial Markets Project. This priority project will be an important element in the GOI program to promote non-oil exports through its focus on improving the financial markets, including the stock, bond, commodity and money markets. The goal of this project is to increase the availability of long-term investment capital by supporting open financial markets. Project inputs will include technical assistance, training, commodities and evaluation.

The executing agency for the project will be the Ministry of Finance, Director General for Monetary Affairs. The Governor of Bank Indonesia, and the Managing Director for Supervision and Internal Development will also be integrally involved. The GOI will contribute the equivalent of $. 3.0 million in cash and kind for this project including $. 1.0 million (equivalent) in private sector contributions.

In addition to the proposed U.S. Fiscal Year (FY) 1988 obligation for this project, it is understood there will be an FY 1989 amendment to add the proposed deregulation fund for state-owned enterprises as earlier discussed.

Looking foward to your favourable response and thank you for your kind cooperation.

Yours sincerely,

Saleh Afiff
Minister of National Development
Planning/Chairman of Bappenas

Cc.: Minister of Finance

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ANNEX C

PROJECT DESIGN SUMMARY

LOGICAL FRAMEWORK

Life of Project:
From FY 88 to FY 94
Total U.S. Funding $9,000,000
Date Prepared: 08/12/88

Project Title & Number: Indonesia - Financial Markets Project (497-0360)

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Program or Sector Goal: The broader objective to which project contributes:	Measures of Goal Achievement:		Assumptions for achieving goal targets:
To increase the availability of long-term investment capital by supporting open financial markets	+ Number of new/expanded firms + Number of new jobs + Per capita income	+ GOI statistics + Other donor studies + GDP per capita	+ GOI maintains the pace of its deregulation programs and policies
Project Purpose:	Conditions indicating purpose has been achieved: End of project status.		Assumptions for achieving purposes:
To increase the number of debt and equity securities and commodity contracts available to investors, and to increase the trading volume of these instruments	+ A permanent and long-range regulatory environment for stocks, bonds and commodities established with operational responsibilities separated from regulatory authority	+ Operational charts for BAPEPAM and ICE. Operational statistics for PPUE or brokers	+ GOI maintains its commitment to liberalization of the market and disengagement from private sector activities
	+ At least 5 private broker/dealers will be able to operate profitably from broker/dealer business alone	+ Income statements, PPUE or BAPEPAM statistics	+ Tax policy revised to provide comparable treatment of some deposits and debt and equity holdings
	+ At least 1 new stock and 2 new bond issues will be marketed each month, and average daily stock trading volume reaches 50,000/day; total stock and bond market capitalization increasing to at least Rupiah 5 trillion	+ BAPEPAM/MOF/PPUE statistics	+ DANAREKSA becomes committed to a more private sector approach in management or deregulates in some other way + Restriction on movement of stock prices is eliminated
	+ Commodity futures and at least two new commodities will be traded on ICE	+ ICE, Ministry of Trade records	+ Deregulation activities continue
	+ Nationwide automated check-clearing system will be operational	+ Bank Indonesia records	
	+ Pension and insurance companies will grow by 50% and increase total stock and bond holdings to 30% of portfolios representing Rupiah 3 trillion	+ MOF records	
	+ Danareksa will reduce percentage of portfolio which is unpledged and will restructure and increase the level of individually owned certificates	+ Danareksa/MOF statistics	

ANNEX C

PROJECT DESIGN SUMMARY

PRELIMINARY LOGICAL FRAMEWORK

Life of Project:
From FY 88 to FY 94
Total U.S. Funding $9,000,000
Date Prepared: 08/12/88

Project Title & Number: Indonesia - Financial Markets Project (497-0360)

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Program or Sector Goal: The broader objective to which project contributes:	Measures of Goal Achievement:		Assumptions for achieving goal targets:
To increase the availability of long-term investment capital by supporting open financial markets	+ Number of new/expanded firms + Number of new jobs + Per capita income	+ GOI statistics + Other donor studies + GDP per capita	+ GOI maintains the pace of its deregulation programs and policies
Project Purpose:	Conditions indicating purpose has been achieved: End of project status.		Assumptions for achieving purposes:
To increase the number of debt and equity securities and commodity contracts available to investors, and to increase the trading volume of these instruments	+ A permanent and long-range regulatory environment for stocks, bonds and commodities established with operational responsibilities separated from regulatory authority	+ Operational charts for BAPEPAM and ICE. Operational statistics for PPUE or brokers	+ GOI maintains its commitment to liberalization of the market and disengagement from private sector activities
	+ At least 5 private broker/dealers will be able to operate profitably from broker/dealer business alone	+ Income statements, PPUE or BAPEPAM statistics	+ Tax policy revised to provide comparable treatment of some deposits and debt and equity holdings
	+ At least 1 new stock and 2 new bond issues will be marketed each month, and average daily stock trading volume reaches 50,000/day; total stock and bond market capitalization increasing to at least Rupiah 5 trillion	+ BAPEPAM/MOF/PPUE statistics	+ DANAREKSA becomes committed to a more private sector approach in management or deregulates in some other way + Restriction on movement of stock prices is eliminated
	+ Commodity futures and at least two new commodities will be traded on ICE	+ ICE, Ministry of Trade records	+ Deregulation activities continue
	+ Nationwide automated check-clearing system will be operational	+ Bank Indonesia records	
	+ Pension and insurance companies will grow by 50% and increase total stock and bond holdings to 30% of portfolios representing Rupiah 3 trillion	+ MOF records	
	+ Danareksa will reduce percentage of portfolio which is unpledged and will restructure and increase the level of individually owned certificates	+ Danareksa/MOF statistics	

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NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Outputs:	Magnitude of Outputs:		Assumptions for achieving outputs:
+ Market deregulation	+ Separating BAPEPAM's regulatory and operational functions; clearer definition of division of regulatory roles	+ GOI statistics + Project evaluations	+ Economic conditions not affected; project beneficiaries' plans remain stable
	+ Strengthened technical capital market skills of MOF and BAPEPAM	+ Project monitoring	
	+ Removing fiscal, monetary and regulatory disincentives for long-term capital investment		
	+ Promoting Danareksa's role as mutual fund for individual investors and reducing its favored status in market		
	+ Separating operational and regulatory functions of the ICE		
+ Increased supply of long-term investment capital	+ Developing standards which encourage pension funds and insurance companies to diversify portfolios		
	+ Revised reserve and liquidity requirements of Bank Indonesia (BI)		
	+ Increasing investor interest in securities through promotional campaigns		
	+ Greater individual and foreign access to markets, e.g., new mutual funds, linkages of markets, restructured Danareksa certificates		
	+ Wider BI issuance of notes and bills		
	+ Creation of BI national credit file		
+ Improved trading capability and structure	+ Developed private sector brokerage through training and TA		
	+ BAPINDO, BPDs and P.T. Bahana sell off equities through stock market		
	+ Automated BI check-clearing system		

Project Title & Number: Indonesia - Financial Markets Project (497-0360)

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS		MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
	+ Increased access to private sector firms trading BI monetary instruments + Deregulation of SOEs through sale of shares on stock exchanges + Sales of Danareksa unencumbered shares + Futures contracts traded at ICE			
Inputs:	Implementation Target (Type & Quantity)			Assumptions for providing inputs:
	USAID Budget (In $000s)	MOF/BI/Private Sector Budgets	+ Project documentation	+ GOI and private sector budgets are forthcoming
+ Technical Assistance over LOP	6,900	1,650		+ Qualified TA will be available
+ Training	1,050	1,050		+ Suitable candidates for training will be available
+ Commodities	700	250		
+ Evaluations/Audits	200	-0-		
+ Contingency	150	50		
TOTAL	9,000	3,000		

ANNEX D

DETAILED SCOPES OF WORK FOR LONG-TERM ADVISORS

I. PROJECT BACKGROUND

The purpose of the Financial Markets Project is to deregulate and institutionally develop Indonesia's stock, bond, commodity and money markets, thereby increasing both the number of debt and equity securities available and the volume of trading of these securities. The anticipated major outputs resulting from this project are:

(1) a deregulated market environment through directing support for continued GOI deregulation of financial markets and for adjusting the roles of the Ministry of Finance (MOF), BAPEPAM, Danareksa, and Bank Indonesia (BI) as necessary to better regulate and promote the capital market. Conversely, the private sector, including PPUE, will gradually assume greater responsibilities for market development and operation. Throughout this project, the GOI will take the lead in initiating reforms, with project resources provided to support such actions. The major regulatory outputs and reforms which are anticipated during the life of project include separating BAPEPAM's regulatory and operational functions, and providing a clearer definition of the division of regulatory responsibilities among the MOF, BAPEPAM and PPUE; strengthening the technical capital markets skills of MOF and BAPEPAM staff, as required for their regulatory role; removing, as possible, the fiscal, monetary and regulatory disincentives for long-term capital investment which are under the control or influence of MOF, BI, BAPEPAM or the GOI Capital Markets Policy Council (to include possible changes in pension and insurance investment guidelines, revision of tax disincentives, evaluation and possible revision of BKPM investment rules, and recommendations on legal changes which would allow the perfection of a security interest; promoting P.T. Danareksa's role as a mutual fund for individual investors while reducing its favored status, restructuring its certificates and liquidating its unpledged portfolio; and separating the operational and regulatory functions of the ICE, with the operational functions preferably being handled by the private sector.

(2) an increased supply of long-term capital available for long-term investment needs. Although regulatory changes cited above will stimulate this process, there are policy, institutional and promotional actions which also will be addressed by the GOI, to include developing standards and practices that encourage pension and insurance firms to diversify their portfolios and invest in debt and equity issues; reviewing bank reserve requirements and revising liquidity ratios to permit a wider range of reserve investments by banks; increasing investor interest in equities and bonds through educational and promotional campaigns; expanding individual and foreign investors' access to the capital market through the establishment of mutual funds, international linkage of the stock, bond and/or commodity markets, changing the structure of certain P.T. Danareksa fund certificates, and other

mechanisms which would attract new investors; working with Bank Indonesia to issue a wider variety of bills, notes and bonds; and creating a Bank Indonesia National Credit File, initially available to institutions but perhaps later to private investors as well, which will serve as an independent source of information concerning the creditworthiness of firms.

(3) an improved trading capability and structure of the Indonesian financial markets. With a view to outreaching the major protagonists involved in trading securities (brokers, dealers, underwriters, P.T. Danareksa, Bank Indonesia and The MOF through its regulatory role). While private sector securities firms should become self-sufficient in the medium-term, this project will support their development during the near-term when little trading will take place in the market and trading expertise will be lacking. Additional ways of promoting the supply of securities will be to encourage the deregulation of state-owned enterprises (SOEs) through the sale of equities on the stock market, and to work with firms considering capital expansion but uncertain of financing alternatives. Specific outputs will include developing the private sector brokerage and underwriting industry through training and technical assistance and through the separation of the operational and regulatory functions of BAFEPAM and the ICE; encouraging the National Development Bank (BAPINDO), Regional Development Banks (BPDs) and the GOI Venture Capital Company (PT Bahana) to sell equity they hold in Indonesian companies through the stock market; establishing a nationwide automated central accounts function and check-clearing system by continuing to support Bank Indonesia's ongoing program; expanding the variety of, and the firms granted access to trade in, Bank Indonesia money market instruments; encouraging the deregulation of SOEs through equity sales; supporting P.T. Danareksa's efforts to sell its unencumbered shares in companies listed on the stock exchange; improving private sector financial managers' awareness and skills in using capital and commodity markets to raise funds and stabilize prices; and permitting futures contracts to be traded through the ICE.

II. THE MOF TECHNICAL ASSISTANCE TEAM

The MOF technical assistance (TA) team to be established under the Financial Markets Project will act as the direct counterpart of the MOF Project Manager (nominated by the Director General for Monetary Affairs, MOF), within the framework of the Project Management Unit (PMU). The PMU will consist of the MOF counterparts, the technical assistance team and the USAID Project Officer.

The TA team will be responsible for managing and coordinating all project inputs including training and commodities. Likewise, the team will be responsible for the full range of project outputs, encompassing elements of policy implementation, institutional development and promotion.

The TA team will consist of six long-term experts, members of a single Contractor unit competitively selected for this project, reporting to the Project Manager at the MOF. An Indonesian sub-contractor for promotional campaigns and various short-term experts as required will also become members of the TA team. That sub-contractor's responsibilities will include the actual conduct and implementation of all promotional campaigns, workshops and seminars to be held in Indonesia. The performance of that sub-contractor will be supervised by the TA team member responsible for training and promotions (see below). Specific tasks for this sub-contractor will include developing TV, radio and/or newspaper advertising and promotional campaigns sponsored by the GOI and the individual financial markets, and handling publicity and logistics for local workshops and seminars.

In addition to the consulting services provided by the MOF TA team and its sub-contractor, there will be a Bank Indonesia (BI) team, financed by the Financial Markets Project under a separate contract, which will report directly to Bank Indonesia and be responsible for all aspects of Bank Indonesia's development programs as delineated in Section I above.

The MOF TA team long-term staff will consist of the following five consultants as described below.

A. <u>Chief of Party/Regulatory Advisor</u>

This consultant will function as the direct counterpart of the MOF Project Manager in providing technical assistance to this project and will be responsible for advising the GOI on all aspects of regulatory reform (as delineated in Paragraph I above). He/she shall also act as team coordinator for the PMU, will supervise all activities undertaken in the name of the Contractor for this project, and will further act as manager of the project's training and commodity inputs. This consultant's responsibilities are listed below.

1. Develop systems and procedures for the successful overall administration, planning, and coordination of all aspects of the project.

2. Design and implement an annual project planning cycle which formulates project workplans and budgets for each individual TA team member in accordance with the GOI's annual planning cycle and guarantee timely disbursement of funds.

3. Design procedures and assist the MOF in the implementation of those procedures directed toward deregulation of financial markets. These procedures are expected to impact directly on adjusting the roles of the MOF, BAPEPAM, P.T. Danareksa, the Indonesian Commodity Exchange (ICE) and Bank Indonesia (BI), to more effectively regulate and promote the Indonesian capital market. A non-exhaustive list of these steps toward deregulation include separating BAPEPAM's regulatory and operational functions, and providing a clearer definition of the division of regulatory responsibilities among the MOF, BAPEPAM and PPUE; removing, as possible, the fiscal, monetary and regulatory disincentives for long-term capital investment which are under the control or influence of MOF, BI, BAPEPAM or the GOI Capital Markets Policy Council, to include possible changes in pension and insurance investment guidelines,

revision of tax disincentives, evaluation and possible revision of BKPM investment rules, and recommendationson legal changes which would allow the perfection of a security interest; promoting P.T. Danareksa's role as a mutual fund for individual investors while reducing its favored status, restructuring its certificates and liquidating its unpledged portfolio; separating the operational and regulatory functions of the Indonesian Commodities Market (ICE), with the operational functions preferably being handled by the private sector.

4. Design procedures and assist the major private sector protagonists (most notably PPUE) in the implementation of those procedures directed toward having the private sector assume greater responsibilities for market development and operation of the capital market.

5. Provide direct supervision for all long-term TA consultants, both Indonesian and expatriate, employed by the Contractor.

6. Supervise the design and implementation of project-related studies, assessments, and demonstrations.

7. Monitor the progress and pace of project implementation.

9. Assist the USAID and the MOF in the design of the mid-term and final project evaluations.

10. Advise the MOF on technical and policy matters related to the project.

11. Supervise the preparation of quarterly reports which review project implementation progress, identify operational or administrative problems, assess the policy environment within which the project is operating and make recommendations to the Project Manager, MOF, and the USAID regarding management, implementation, and policy issues which require special attention during the current fiscal year.

12. Supervise the preparation of an annual report which reviews project implementation progress, identifies operational or administrative problems, assesses the policy environment within which the project is operating and makes recommendations to the Project Manager, MOF, and the USAID regarding management, implementation, and policy issues which require special attention in the upcoming fiscal year. Based on an anticipated start-up date for the TA team of April 1, 1989, the issues paper will be submitted at the end of March of each year, beginning in March 1990, and its recommendations will be considered in the project planning cycle for the ensuing "project year" beginning each April.

Qualifications

In order to carry out these responsibilities this Consultant should have a minimum of 10 years working experience in capital market development and regulation, preferably with respect to second tier or over-the-counter markets. The consultant should have at least a masters degree in business or economics, a legal degree or an equivalent degree or certification. Prior experience working in a developing country, an understanding of USAID administrative procedures, and/or prior experience with project management in the context of regulatory reform are qualities highly sought after for this position. Indonesian language capability would be an advantage but is not required. Funds for language training will be included in the contract.

B. Deputy Chief of Party/Regulatory Advisor

Acting as the Chief of Party's alter-ego, this position will be reserved for an Indonesian professional well versed in the local legal and regulatory systems who will help ensure that project documentation and recommendations are appropriately designed and structured for Indonesia. In his/her role as alter-ego to the Chief of Party, this consultant will provide direct technical assistance to GOI and private sector capital market counterparts in all of the tasks listed above for the Chief of Party in the latter's absence, functioning as the direct counterpart of the MOF Project Manager in providing technical assistance to this project and will be responsible for advising the GOI on all aspects of regulatory reform (as delineated in Paragraph I above). In the Chief of Party's absence he/she shall also act as team coordinator for the PMU, supervising all activities undertaken in the name of the Contractor for this project, and will further act as manager of the project's training and commodity inputs. The additional responsibilities for this consultant are listed below.

1. As mentioned above, an Indonesian sub-contractor for promotional campaigns will also become a member of the TA team. That sub-contractor's responsibilities will include the actual conduct and implementation of all promotional campaigns, workshops and seminars to be held in Indonesia. Although that sub-contractor's performance will be supervised by the TA team member responsible for training and promotions (see below), the Deputy Chief of Party will provide Indonesian-specific technical directions on capital market promotional campaigns to the sub-contractor.

2. In conjunction with the specific training plans developed by the TA team's Training/Promotion Manager, advise the MOF, BAPEPAM, P.T. Danareksa, PPUE, Bank Indonesia and other concerned organizations in the Indonesian capital market, on human resource development plans which should be implemented in order to strengthen the technical capital markets skills of staffs of those organizations.

3. Function as liaison between the MOF, other GOI capital market entities, the USAID, and private sector capital market protagonists on all technical, administrative, and financial matters related to the project.

Qualifications

In order to carry out these responsibilities this Consultant should have a minimum of 10 years working experience in capital market development and regulation in the Indonesian context, preferably with respect to second tier or over-the-counter markets. The consultant should have at least a masters degree in business or economics, a legal degree or an equivalent degree or certification. An understanding of USAID administrative procedures and/or prior experience with project management in the context of regulatory reform are highly sought after for this position. Indonesian language capability is essential and fluency in English is also required.

C. Investment Analyst

This consultant will work primarily with institutional investors, especially the pension and insurance companies, and P.T. Danareksa, on portfolio management and promotion programs. His/her additional responsibilities are listed below.

1. At the request of institutional investors, prepare recommendations on the use of those organizations' funds, serving as financial consultant to their management in the diversification of their portfolios.

2. Assist those investors in specifying the elements necessary for complete information systems pertaining to investments, and assist in the design of systems for better utilization of all funds becoming available to those organizations, with due regard to the requirements for liquidity, and security.

3. Assist those investors in the development of manuals of procedure for investment accounting and control, forms and practices.

4. Assist the TA team Chief and Deputy Chief of Party in identifying short-term technical assistance needs of institutional investors and in developing suitable scopes of work for that assistance, and recruitment of consultants.

5. Within the purview of his/her responsibilities, provide day-to-day supervision for all short-term consultants, both Indonesian and expatriate, employed by the Contractor.

6. Within the purview of his/her responsibilities, assist the Training/Promotions Manager in the development of specific training plans to enhance the technical capital markets skills of staffs of investor organizations.

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7. Assist in the design and implementation of project-related studies, assessments, and demonstrations, as required.

8. Provide financial management and control of operations within his/her purview.

9. Monitor the progress and pace of implementation of this project component.

10. Assist the Chief of Party in the design of the mid-term and final project evaluations.

11. Provide quarterly reports which review implementation progress on consultant's activities, identifying operational or administrative problems, assessing the policy environment within which the project is operating and making recommendations to the Chief of Party on management, implementation, and policy issues which require special attention during the current fiscal year.

12. Provide annual reports which review implementation progress on consultant's activities, identifying operational or administrative problems, assessing the policy environment within which the project is operating and making recommendations to the Chief of Party on management, implementation, and policy issues which require special attention in the upcoming fiscal year.

Qualifications

In order to carry out these responsibilities this Consultant should have a minimum of seven years working experience in portfolio management for institutional investors, either in the capacity of an external consultant to those investors or as an employee of (an) institutional investor(s). Ideally, those institutions where the consultant has gained experience would include (public or private sector) pension funds, insurance companies or mutual funds. The consultant should have at least a masters degree in business or economics, a legal degree or an equivalent degree or certification. On-the-job experience may be substituted for graduate level experience on a ratio of up to three years hands-on experience for a maximum of two years of graduate school studies.

Relevant on-the-job experience should include hands-on use of computer programs utilized for investment decision making. Prior experience working in a developing country, an understanding of USAID administrative procedures, and/or prior experience with project management in the context of regulatory reform are qualities highly sought after for this position. Indonesian language capability would be an advantage but is not required. Funds for language training will be included in the contract.

D. Trade and Underwriting Specialist

This consultant will collaborate closely with the private brokers and underwriters community, PPUE, and private industrial or commercial firms desiring to list shares or bonds on the markets. He/she will also develop educational programs for market promotion. His/her additional responsibilities are listed below.

1. At the request of a variety of institutional sources (private brokers, underwriters, PPUE, private industrial or commercial firms), assist those institutions in developing procedures and programs for issuing debt and equity instruments on the Indonesian stock exchanges.

2. Help those institutions on designing improved procedures for interacting with members of the financial markets in collecting and providing relevant information for the development of prospectuses or other reporting data required for debt or equity share listings.

3. Assist those institutions to prepare analytical checklists and other aids and models for decision memoranda relating to debt or equity share listing.

4. Assist those institutions in specifying the elements necessary for complete information systems pertaining to tracking financial and legal compliance requirements they will face as issuers of debt and equity instruments.

5. Assist those institutions in the development of manuals of procedure for underwriting accounting and control, forms and practices.

6. Assist the TA team Chief and Deputy Chief of Party in identifying short-term technical assistance needs of his/her counterpart institutions and in developing suitable scopes of work for that assistance, and recruitment of consultants.

7. Within the purview of his/her responsibilities, provide day-to-day supervision for all short-term consultants, both Indonesian and expatriate, employed by the Contractor.

8. Within the purview of his/her responsibilities, assist the Training/Promotions Manager in the development of specific training plans to enhance the technical capital markets skills of staffs of targeted institutions which issue securities.

9. Assist in the design and implementation of project-related studies, assessments, and demonstrations, as required.

10. Provide financial management and control of operations within his/her purview.

11. Monitor the progress and pace of implementation of this project component.

12. Assist the Chief of Party in the design of the mid-term and final project evaluations.

13. Provide quarterly reports which review implementation progress on consultant's activities, identifying operational or administrative problems, assessing the policy environment within which the project is operating and making recommendations to the Chief of Party on management, implementation, and policy issues which require special attention during the current fiscal year.

14. Provide annual reports which review implementation progress on consultant's activities identifying operational or administrative problems, assessing the policy environment within which the project is operating and making recommendations to the Chief of Party on management, implementation, and policy issues which require special attention in the upcoming fiscal year.

Qualifications

In order to carry out these responsibilities this Consultant should have a minimum of seven years working experience in securities underwriting for an investment banking institution. The consultant should have at least a masters degree in business or economics, a legal degree or an equivalent degree or certification. On-the-job experience may be substituted for graduate level experience on a ratio of up to three years hands-on experience for a maximum of two years of graduate school studies.

Relevant on-the-job experience should include hands-on preparation of investment prospectuses, managing "disclosure and compliance" requirements within the legal and financial framework. Experience should also include hands-on use of computer programs utilized for the aforementioned purposes. Prior experience working in a developing country, an understanding of USAID administrative procedures, and/or prior experience with project management in the context of regulatory reform are qualities highly sought after for this position. Indonesian language capability would be an advantage but is not required. Funds for language training will be included in the contract.

E. Training/Promotions Manager

This consultant will arrange for and manage all short-term training programs, promotional campaigns and local/regional seminars and workshops as described in Section 3.4.2. of the Project Paper. His/her additional responsibilities are listed below.

1. Prepare the scope of work for the competitive contract selection of the Indonesian sub-contractor for promotional campaigns. That sub-contractor's responsibilities will

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include the conduct and implementation of all promotional campaigns, workshops and seminars to be held in Indonesia. Specific tasks for this sub-contractor will include developing TV, radio and/or newspaper advertising and promotional campaigns sponsored by the GOI and the individual financial markets, and handling publicity and logistics for local workshops and seminars.

2. Within the purview of his/her responsibilities with the Indonesian sub-contractor for promotional campaigns, provide day-to-day supervision for all short-term consultants employed by that sub-contractor, and provide day-to-day supervision for all other short-term consultants, both Indonesian and expatriate, employed by the Contractor.

3. Assist those protagonists impacted upon by this project (Indonesian institutions in the stock, bond, commodity and money market community, issuers of securities, and, as noted in the scope of work for the Bank Indonesia Senior Banking Expert, requests from Bank Indonesia) in specifying the elements necessary to develop their human resource plans pertaining to capital market technical skills.

4. Assist the TA team Chief and Deputy Chief of Party in identifying short-term human resource technical assistance needs for the project, and in developing suitable scopes of work for that assistance, and recruitment of consultants.

5. Assist in the design and implementation of project-related studies, assessments, and demonstrations, as required.

6. Provide financial management and control of operations with his/her purview.

7. Monitor the progress and pace of implementation of consultant's project component.

8. Assist the Chief of Party in the design of the mid-term and final project evaluations.

9. Provide quarterly reports which review implementation progress on consultant's activities, identifying operational or administrative problems, assessing the policy environment within which the project is operating and making recommendations to the Chief of Party on management, implementation, and policy issues which require special attention during the current fiscal year.

10. Provide annual reports which review implementation progress on consultant's activities, identifying operational or administrative problems, assessing the policy environment within which the project is operating and making recommendations to the Chief of Party on management, implementation, and policy issues which require special attention in the upcoming fiscal year.

Qualifications

In order to carry out these responsibilities this Consultant should have a minimum of seven years working experience in human resource development or public relations for (a) major financial institution(s), either in the capacity of an external consultant to those institutions or as an employee of (an) institution(s). Ideally, those institutions where the consultant has gained experience were (public or private sector) pension funds, commercial or investment banks, insurance companies or mutual funds. The consultant should have a doctorate degree in education or an equivalent degree or certification. On-the-job experience may be substituted for graduate level experience beyond the masters degree level on a ratio of up to three years hands-on experience for a maximum of two years of graduate school studies.

Prior experience working in a developing country, an understanding of USAID administrative procedures, and/or prior experience with project management in the context of regulatory reform are qualities highly sought after for this position. Indonesian language capability would be an advantage but is not required. Funds for language training will be included in the contract.

F. Administration/Logistics Manager

This consultant will coordinate and manage all aspects of commodity procurement for the project and logistical support for the team. His/her additional responsibilities are listed below.

1. Develop systems and procedures for the successful overall administration and logistical support for the team.
2. Coordinate a consolidation of quarterly and annual project workplans and budgets.
3. Assist team members and GOI counterparts in identifying appropriate project-related commodities, and prepare necessary documentation to procure those goods and services.
4. Coordinate the identification of all project short-term technical assistance needs, the development of suitable scopes of work for that assistance, and recruitment of consultants.
5. Provide overall supervision for all short-term consultants, both Indonesian and expatriate, employed by the Contractor.
6. Provide overall financial management and control of TA operations.

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Qualifications

In order to carry out these responsibilities this Consultant (an Indonesian national) should have a minimum of seven years working experience in adminstrative, procurement and financial management in the Indonesian context. The consultant should have at least a bachelors degree in business, finance or commercial law, or an equivalent degree or certification. An understanding of USAID administrative procedures and/or prior experience with administrative management in the context of logistical support for an expatriate technical team are highly sought for this position. Indonesian language capability is essential and fluency in English is also required.

III. SHORT-TERM TECHNICAL ASSISTANCE

The MOF team will be augmented by substantial short-term expertise which will be jointly funded by this project and the PRE Bureau Financial Markets Project. The total level of short-term assistance for the project team is estimated at 60 person months, of which it is anticipated that the PRE Bureau will finance 25 percent under buy-in arrangements. Short-term assistance anticipated during the life of project under this team is:

+ Deregulation of State-Owned Enterprises	24 person-months
+ Commodity Market Experts	12 person-months
+ Stock/Bond Experts	12 person-months
+ Pension/Insurance Experts	6 person-months
+ Regulatory/Legal Experts	6 person-months

As noted in the individual long-term scopes of work, the MOF TA team will be responsible for confirming the need for specific short-term assistance, preparing the scopes of work for each expert, recruiting the qualified experts needed, managing the experts' work, and integrating results of their services into the Financial Markets Project. It should be further noted that, to the greatest extent possible, proposed short-term experts in the foregoing fields should be identified and approved as part of the contract technical proposal and bidding process.

IV. THE TECHNICAL ASSISTANCE TEAM SUB-CONTRACTOR

In addition to the foregoing MOF TA team members, an Indonesian sub-contractor will also be associated with the MOF team. That sub-contractor's responsibilities will include the actual conduct and implementation of all promotional campaigns, workshops and seminars to be held in Indonesia, and its performance will be supervised by that member of the PMU team responsible for training and promotions. Specific tasks for this sub-contractor will include developing TV, radio and/or newspaper advertising and promotional campaigns sponsored by the GOI and the individual financial markets, and handling publicity and logistics for local workshops and seminars.

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V. THE BANK INDONESIA TEAM

In addition to the consulting services provided by the MOF TA team and its sub-contractor, there will be a Bank Indonesia (BI) team which will report directly to Bank Indonesia and be responsible for all aspects of BI's development programs (as delineated in Section I above). This team will be competitively selected and hired under a Host Country Contract. The team will consist of one long-term advisor, the Senior Banking Expert, and short-term assistance as noted below. The Senior Banking Expert will report directly to Bank Indonesia and be responsible for all aspects of BI's development programs as delineated in Section I above. His/her additional responsibilities are listed below.

Senior Banking Expert

As noted above, this consultant will function as the direct counterpart of the Bank Indonesia (BI). During the consultant's tenure with BI, he/she will work under the guidance of senior Bank Indonesia officials and review aspects of Bank operations which Bank Indonesia would like to improve in areas concerning deregulation of Indonesian financial markets, particularly in terms of money market operations. This consultant's responsibilities are listed below.

1. Assist BI in identifying major areas of operations that warrant further analysis and assistance, advise BI on appropriate steps to follow, and to the extent not possible, outline the type, magnitude and potential source of assistance that will allow those analysis to be performed.

2. Design and implement an annual project planning cycle which formulates project workplans and budgets for the consultant's project component.

3. Design procedures and assist BI in the implementation of those procedures directed toward deregulation of financial markets. These procedures are expected to impact directly on adjusting the roles of the MOF, BAPEPAM, P.T. Danareksa, and Bank Indonesia (BI), to more effectively regulate and promote the Indonesian capital market.

4. In conjunction with the specific training plans developed by the TA team's Training/Promotion Manager, advise BI on human resource development plans which should be implemented in order to strengthen the technical financial and capital markets skills of BI staff.

5. Review BI's policies governing commercial bank "exposure" and relevant accounting, reporting, human and automated data processing needs.

6. Based on the foregoing, develop systems and procedures for the successful overall administration, planning, and coordination of all aspects of the commercial bank reserve management procedures, and to the extent applicable to project objectives, the impact of those reserves on BI foreign exchange reserves.

7. Advise BI management on the appropriateness of current monetary management procedures, including rediscount procedures, open market procedures, etc., and those elements of accounting and computerization supporting monetary management. Special attention will be paid to the extent of computerization required as it relates to inter-bank accounting and funds flow between BI and participating members of the banking system.

8. Through a comprehensive survey of needs for types of monetary instruments which should be brought into use, assist BI in the development and issuance of bills and notes for trading in Indonesian primary and secondary markets.

9. Based on BI's initial implementation plan, oversee the development of a national credit file which will provide a clearing house of information on the financial condition of major customers of the Indonesian public and private banking system. A detailed plan of this will be provided with the Request for Proposals (RFP).

10. Oversee the continued development and provide short-term assistance for supervision of BI's long-term central accounts and check clearing automation project. A detailed plan of this will be provided with the RFP.

11. Supervise the design and implementation of project-related studies, assessments, and demonstrations.

12. Provide overall financial management and control of operations under his/her purview.

13. Monitor the progress and pace of project component implementation.

14. Assist the USAID and BI in the design of the mid-term and final project evaluations.

15. Function as liaison between BI and other PMU entities on all technical, administrative, and financial matters related to the project.

16. Advise the MOF on technical and policy matters related to the project.

17. Prepare quarterly reports which review implementation progress on this project component, identifying operational or administrative problems, assessing the policy environment within which the project component is operating and making recommendations to the PMU and USAID regarding management, implementation, and policy issues which require special attention during the current fiscal year.

18. Prepare an annual report which reviews implementation progress of this project component, identifying operational or

administrative problems, assessing the policy environment within which the project component is operating and making recommendations to the PMU and USAID regarding management, implementation, and policy issues which require special attention in the upcoming fiscal year. Based on an anticipated start-up date for the TA team of April 1, 1989, the issues paper will be submitted at the end of March of each year, beginning in March 1990, and its recommendations will be considered in the project planning cycle for the ensuing "project year" beginning each April.

Qualifications

In order to carry out these responsibilities this Consultant should have a minimum of 15 years of progressively responsible working experience in central bank or large money center bank operations, development and regulation, ideally also involving both central bank money market operations and second tier markets, either in the capacity of an external consultant to those types of institutions or as an employee of a central bank (preferably one of the Federal Reserve Banks in the US) or a money market instruments dealer. At least five years' experience as a senior manager with a central bank or money center bank is required. Conceivably, a combination of experience with the foregoing institutions could be considered. The consultant should preferably have a doctorate degree in business or economics, a legal degree or an equivalent degree or certification. On-the-job experience may be substituted for graduate level experience on a ratio of up to three years hands-on experience for a maximum of two years of graduate school studies.

Relevant on-the-job experience should include hands-on use of computer programs utilized for management decision making. Prior experience working in a developing country and/or prior experience with project management in the context of regulatory reform are qualities highly sought after for this position. Indonesian language capability would be an advantage but is not required. Funds for language training will be included in the contract.

This expert will also manage short-term technical assistance inputs for Bank Indonesia priority programs. This short-term assistance, to be provided under the BI team contract, is expected to total approximately 60 person months over the life of the project, with PRE Bureau also providing 25 percent of the cost of these short-term experts. The estimated breakdown of short-term technical assistance for Bank Indonesia is as follows:

+ Automation/Data Telecommunications	30 person-months
+ National Credit File	24 person-months
+ Money Markets	6 person-months

Bank Indonesia training programs will be administered by the MOF team Training Manager at the request of Bank Indonesia.

ANNEX E

TECHNICAL AND FINANCIAL ANALYSIS

This annex contains four parts: (1) a general definition of financial markets, and discussions of (2) the capital market, (3) Bank Indonesia and the money market, and (4) the commodities market.

1. DEFINITION OF FINANCIAL MARKETS

1.1 THE MONEY MARKET

The money market, which provides short-term finance, has no physical marketplace per se. It consists of commercial, investment and merchant banks, central banks, mutual funds, and dealers trading securities by telephone and/or telex. The money market serves the needs of bulk users of funds, such as governments, banks, pension funds, insurance companies and other financial institutions which need to be able to invest or borrow funds for a short term on a continuous basis. The instruments commonly traded in a money market are short-term government securities such as bills and notes, government agency securities, time deposits, certificates of deposit, commercial paper, banker's acceptances and repurchase agreements.

1.2 THE CAPITAL MARKET

The capital market provides medium- and long-term finance, unlike the money market which provides short-term finance. Another difference between the money and capital markets is that the capital market includes equity finance. The availability of equity finance is crucial for economic growth. It is a necessary part of the financial foundation of all businesses and is especially important for new ventures which face uncertain cash flows.

To best understand the capital market, it is helpful to divide it into the nonsecurities and securities segments.

The nonsecurities segment of the capital market, as its name implies, includes transactions which are not evidenced by negotiable securities. In other words, the securities are not liquid or freely traded. The initial investors, therefore, usually hold the securities until their maturity, conversion or redemption. Examples of such transactions are loans, leases, mortgages and partnerships. Financial institutions which usually participate in the nonsecurities segment of the capital market are commercial, mortgage and development banks, insurance companies, pension funds and leasing companies.

The securities segment of the capital market generally is longer term than the nonsecurities segment, although both tend to be longer term than the money market. The primary difference between these two segments is that the debt and equity securities issued in the securities segment are negotiable. The issuers of these securities want long-term finance but the investors usually do not want to commit their funds for an equally long term so they require that the securities be negotiable. Thus, the issuers obtain long-term finance while the initial investors can sell the securities to other investors whenever they want. Stocks and bonds, which are traded easily in the secondary market, are examples of such negotiable securities.

Investors in the securities segment of the capital market include commercial and investment banks, securities brokers and dealers, insurance companies, pension funds, trust departments, mutual funds and individuals. It is usually the case that financial institutions will invest in a developing capital market before individuals are willing to do so. The trading of securities can occur in a fixed place, like a stock exchange, or over telephones and computers, as is the case with over-the-counter markets.

Two aspects of the securities segment of the capital market are discussed here: the primary market and the secondary market.

New securities being sold for the first time are sold in the primary market. Issuers receive funds from investors in exchange for securities. Issuers can then invest these funds in capital assets or use them for other purposes. The sale of these securities from issuers to investors occurs through financial intermediaries such as investment, commercial and merchant banks. These intermediaries are also responsible for structuring the securities, advertising the sale, and making a market in the securities in the secondary market.

The secondary market entails the trade of securities between investors after the securities have been sold in the primary market. In this case, the transfer of securities and funds is between investors and does not involve issuers. A liquid secondary market is necessary to convince investors to buy securities in the primary market. Prices prevailing in the secondary market are used as a guideline for the price at which issuers could sell additional securities in the primary market. Secondary market trading usually occurs among brokers and dealers acting for themselves or on the behalf of other investors.

The primary and secondary markets are complimentary. The primary market needs the secondary market to assure investors of liquidity and the secondary market needs the primary market to provide a supply of securities.

1.3 THE COMMODITIES EXCHANGE

The commodities exchange is an established and organized market, like a stock exchange. Brokers and dealers trade contracts on the floor of the exchange (not over telephones or computers) for themselves or their customers. The contracts traded can be either physicals contracts or futures contracts. In most commodity exchanges, futures contracts are the predominate, if not only, type of contract traded.

Physicals contracts are structured to reflect each individual transaction. Buyers and sellers negotiate the specific provisions of the contract, such as quantity, quality, price, date of delivery, place of delivery and other matters. The contract is ultimately satisfied by paying for and delivering the specified commodity in accordance with the provisions of the contract.

Futures contracts are standardized contracts with only the price and date of delivery being open to negotiation. The quantity, quality and place of delivery is the same for all futures contracts of a specific commodity. Buyers or sellers usually do not satisfy futures contracts by paying for or delivering the specified commodity, but by closing out their position with the commodity exchange's clearinghouse. Closing out a position requires that, before the maturity of a futures contract, the buyer and seller trade another contract which is opposite to and cancels the contract purchased previously. For example, an investor who has bought a December rubber futures contract would close out his position by selling an identical futures contract so that at the clearinghouse his two contracts cancel each other out. It is very rare to satisfy a futures contract by trading the specified commodity.

Two types of investors trade futures contracts: hedgers and speculators. Hedging is a protective procedure designed to minimize commodity marketing and processing losses that are due to adverse price fluctuations. Hedging requires the purchase or sale of the necessary futures contract that will, when combined with a physicals transaction already made or about to be made for the same commodity, result in offsetting gains and losses as prices change over time. Hedgers seek to avoid risking their capital.

Speculators, on the other hand, voluntarily risk their capital with the expectation of making a profit. Speculators attempt to buy when the price is low and sell when the price is high. Since hedgers and speculators take opposite sides of the market, both are needed for a commodities exchange to operate.

2. THE CAPITAL MARKET

The successful development of Indonesia's financial sector must take into consideration the factors affecting the supply of and demand for capital, as well as the efficiency of the capital market itself. Efficiency includes the prevailing political and economic conditions, the regulatory and legal environment, and the role of supporting agencies and institutions.

Therefore, after briefly describing the capital market in Indonesia, this section analyzes: 1) the demand for capital (focusing on the bond and equity markets and the banking system), 2) the supply of capital (focusing on insurance companies and pension funds), and 3) the regulatory and trading environment. (The commodities market is covered separately in Section 4 of this Annex.) This section concludes with a consideration of the reforms necessary to promote further financial sector development.

The capital market brings together investors (sources of capital) and users of funds (demand for capital). It is usually divided into the securities and non-securities segments, both of which can be further classified into debt and equity segments. Figure 1 depicts the interaction of investors and users of funds through the capital market and the types of financial institutions and instruments commonly utilized. It also illustrates the interdependency of the elements of the market. Funds flow from the sources (supply side) of capital, through financial intermediaries into the various financial instruments available in the market (both debt and equity) to the users of capital.

FIGURE 1: COMPONENTS OF THE CAPITAL MARKET

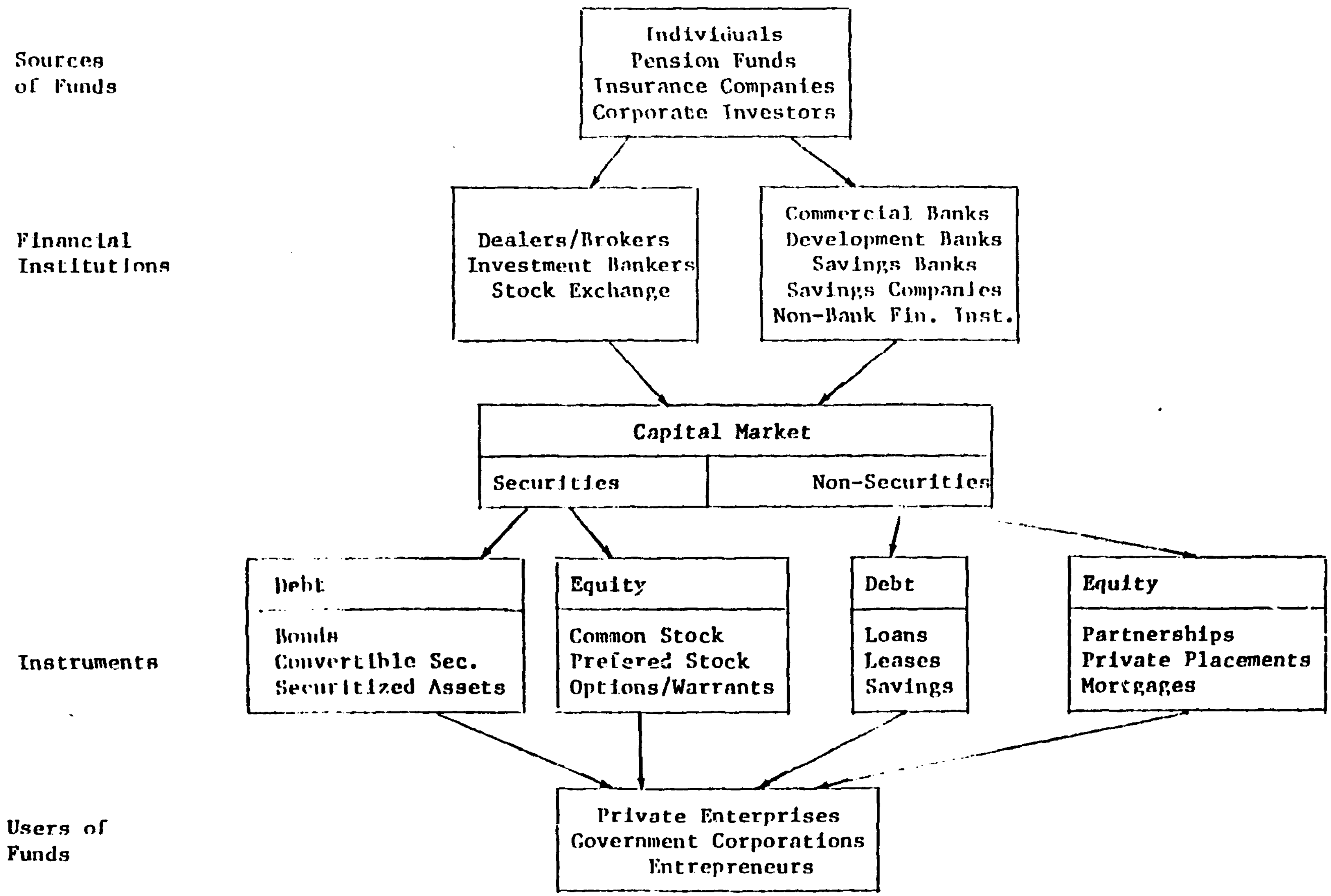

Figure 2 shows Indonesia's current sources and uses of funds. This bar graph clearly indicates the almost total dominance of debt financing as a source of capital in Indonesia. The indicated size of private equity investment, either national or foreign joint-venture, is optimistic. The figures are based on BKPM (the state-owned investment coordinating board) approvals over the last 20 years and not on actual funds invested in private sector projects, which are difficult to verify. However, recent Bank Indonesia statistics indicate that actual private sector investment is only 43-60% of the approvals indicated in Figure 2. Adjusting the private equity investment figures accordingly only serves to further emphasize the overwhelming role of bank loans as the primary source of funds in Indonesia.

The Indonesian banking system is by far the most powerful driving force in the financial sector, providing over 90% of all debt financing and gathering almost 22% of total invested funds in the form of savings deposits. The fragility of this situation is apparent when one realizes that there is virtually no contractual long-term lending. The majority of bank loans mature in 60 days or less. Such a short-term financial structure is highly vulnerable to fluctuations in interest rates and funds availability.

Although the bond market expanded in early 1988, the total of all funds raised in the securities sector of the capital market (both share issues and bond sales) is only Rp. 1,184 billion, an almost insignificant portion of all financings. Compared to demand, the supply of long-term capital is severely limited. Most of the demand will have to be met through increased activity in the securities sector of the capital market, which must be further developed to mobilize capital resources more efficiently and provide the long-term funds required for economic development.

2.1 DEMAND FOR CAPITAL

The demand for capital, particularly long-term capital to sustain economic growth, is quite strong in Indonesia. This demand is most easily evidenced by the continuous increase in corporate bank debt which represents the primary source of funding in the economy. Additionally, the statistics provided by BKPM indicate that applications for expansion permits by local companies are increasing. Public and private sector enterprises continually express their desire for easier access to long-term capital sources, particularly bank loans.

It has been argued that capital has been provided on a de facto long-term basis through the roll-over arrangement of short-term loans. A roll-over arrangement, however, normally involves a considerable degree of uncertainty. From the viewpoint of borrowers, it is not certain whether banks are going to renew the loan. In addition, banks have a greater negotiating edge with roll-over arrangements because they can review the credit conditions of the borrowers at each renewal. Based on their findings and judgment, banks often change the terms of loans, such

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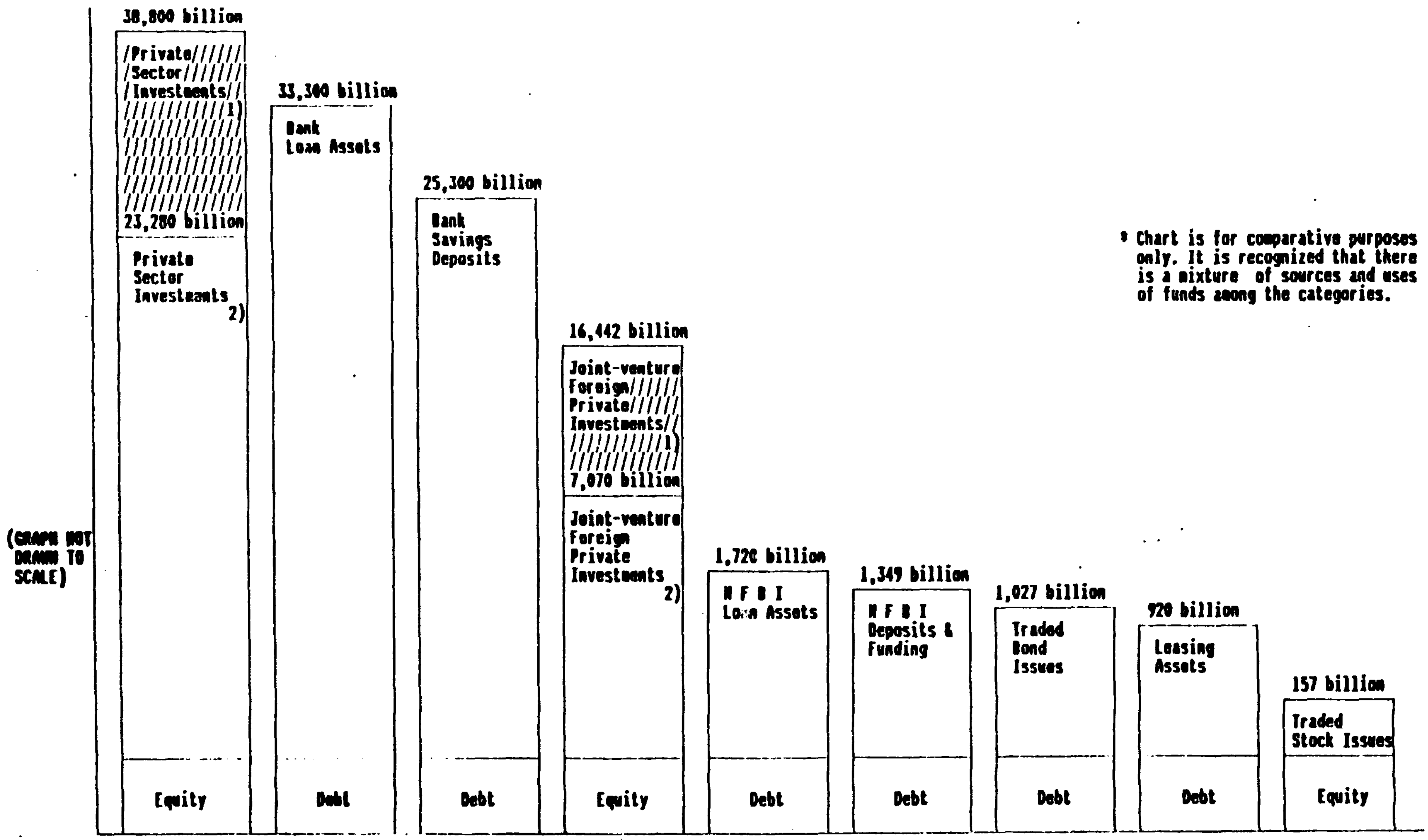
FIGURE 2: USES OF FUNDS, INDONESIA 6/30/88

(Rupiah)



1) Cumulative investment totals as approved through BKPM for period of 3/68 - 3/88.

2) Cumulative investment totals realized as reported by BKPM 3/68 - 3/88. (PMA 43% of approved) (PMDN 60% of approved).

as increasing interest rates. On the other hand, if long-term loans were available, it would be much easier for entrepreneurs to undertake long-term financial planning and determine long-term budgeting and capital expansion requirements. To finance long-term investment projects, such as the expansion of plant or purchase of machinery and equipment, entrepreneurs must be able to formulate definite plans for their financial projections. This justifies efforts to strengthen the long-term supply of capital to meet such demand.

Currently, foreign joint-venture companies are not allowed to borrow on a long-term basis through the local banking sector because there is concern that their domestic long-term borrowing activities would crowd out the allegedly small domestic capital market and because the government prefers that they import money from abroad. This policy is not valid from the viewpoint of either capital market development or development of the private sector. The capital market, in this case a long-term loan market, can develop only with a growing level of supply and demand.

It is obvious that other sources of long-term capital must be developed and new financial instruments must be introduced in the form of securities or long-term debt obligations. These sources should include corporate bonds, securitized asset obligations, commercial paper, shares and domestic and foreign venture capital. It is also important that underwriters, market makers, brokers and dealers be developed and that investors in and issuers of securities be supported.

2.1.1 Bond Market

Despite the increase in new bond issues during the first half of 1988, including a private sector corporate bond, the bond market in Indonesia is not well developed nor is it operating efficiently. In fact, a strong argument can be made that until recently there was not a market for these debt issues at all.

Between 1983 and 1987, 16 separate bond issues were floated on the Indonesian stock exchange. The bonds represented a cumulative nominal value (issue price) of Rp. 536 billion (approximately $319 million at current exchange rates). However, all 16 bonds were issued by only three state-owned enterprises (P.T. Jasa Marga, Bapindo and P.T. Papan Sejahtera), all the bonds were for five years, and virtually 100% of each issue was sold directly to other government agencies, primarily P.T. Taspen (the government employee pension fund) and P.T. Danareksa (the government owned unit trust company). In addition to the "managed recycling" of these funds through the government system, the interest rates paid on the bonds were artificially established and usually were below prevailing interest rates paid on short-term bank deposits. There has been virtually no secondary market trading in these bonds. Once sold to Taspen or Danareksa, the bonds have been held until maturity, mainly because these agencies were reluctant to recognize any loss upon sale. Since the bonds were sold initially at par, such a loss was almost certainly due to their uncompetitive coupon rate.

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Indonesia does not appear to have many institutions or individual investors seeking long-term investments. The main investors in bonds are the pension funds and insurance companies. Only those institutions with a long-term orientation to their investment portfolio can justify the low yields on bonds when compared to short-term interest rates. Pension funds and insurance companies can rationalize such an investment because they need to match assets with liabilities and secure a stable flow of long-term income. For other investors who are less long-term oriented, the current coupon rates are not attractive because of the prevailing high interest rates paid on bank deposits as well as the tax-free status for interest income for these deposits. Pension funds, however, pay no taxes so they are indifferent to the tax status of investment alternatives.

The continued high interest rate environment in Indonesia, in effect since the banking reforms of 1983, and a reduction in the government's dominance of the bond market have created a situation in which bond issuers have been forced to increase their coupon rate with each new issue. Bond interest rates have increased steadily from a low of 15.5%, paid semi-annually, to 18.5%, paid quarterly. Although these more frequent interest payments increase the actual yield to the investor, bonds are still not competitive with short-term deposit rates on an after-tax basis. The government has addressed this issue by granting pension funds a tax exemption for bond income, but this does not solve the underlying problem of pricing and realistic interest rates in the economy. A more detailed discussion of the role of pension funds as a source of capital is presented in Section 2.2.

Although the bond market will continue to face structural difficulties in the near future, the prospects for the gradual development of this market are quite positive. The demand for bond securities from pension funds, insurance companies, and the commercial banks should increase as a result of intended legislation and through the GOI's development actions.

The basic strategy for developing the bond market should have two components. One should be to increase the number and variety of debt securities. The other should be to cultivate the market by stimulating the supply of and demand for securities, providing potential bond holders with special incentives, or creating demand by establishing a new policy framework.

Bonds issued by public enterprises should be flexible in their structures and pricing. These organizations are in need of long-term capital, which they have to raise on their own because of the strained conditions of the government budget. Because of the services they render, many public corporations may be able to find investors in their securities more easily than private corporations. In addition, the government's back-up for their activities should also make these bonds attractive. These bonds could also be made eligible assets for banks and financial institutions to meet their liquidity requirements.

However, two major issues must be resolved before innovative public sector bond issues can materialize. The first concern is the identification of potential issuers and investors and how to cultivate such a market. Because the capital market in Indonesia is still not mature, issuing such bonds will require careful planning including an assessment of the existing market, or perhaps even creating a new market. There are two basic ways to develop the bond market. One is to sell bonds to the immediate beneficiaries of the services provided by these public enterprises. These bonds could be sold to help finance the investment programs of public enterprises to increase their servicing capacity. The following paragraphs give some examples of potential issuers and investors.

Telephone Subscriber Bonds. These bonds are to be issued by the public telephone company for new telephone subscribers (private individuals or corporate institutions) as a condition for installation. This method of raising funds has an advantage which is markedly different from the policy of raising telephone charges to increase the self-financing capability of the issuing agency, Perumtel. Since recovering construction costs by raising telephone service charges is a prolonged process, it does not free the agency from raising the funds immediately necessary for the construction. In contrast, issuing subscriber bonds would substantially reduce the immediate fund raising requirements and free the company from searching for financing or buyers for bonds sold to the public at large.

Telephone subscriber bonds can be: 1) registered or bearer bonds; 2) interest-bearing or discount bonds; and 3) with serial and/or term bonds. Capitalizing interest or issuing discount bonds would relieve the issuer of the burden of servicing the debt during the early years when construction expenditures are high and revenues low. Commercial banks could act as trustee and receive payments from the subscribers and validate authorizations for installation. They could also provide a custodian service to their bond holders. The bonds should be listed at the exchange to help encourage trading in the secondary markets. Such trading would necessarily be at a discount from the purchase price because secondary market purchasers would not receive the benefit of a telephone installation.

Construction Bonds. These bonds could be issued to developers as a condition for obtaining a construction permit for commercial buildings in metropolitan areas. A public body may function as the financial manager to issue such bonds and distribute the proceeds to various public authorities which need long-term funds to finance their urban development services. The government, whether national or local, invests substantial amounts of money for developing the urban infrastructure. Often, however, developers along the major road network on which such services are concentrated benefit the most from such improvements through an increased resale value of the property and higher rental incomes. Theoretically, the government should be able to recover the investment cost through increased tax revenues, but this process takes time and costs usually cannot be fully recovered.

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Housing Bonds. Housing financing institutions may be able to issue bonds directly to prospective homeowners. Such bond holders could be given access to home mortgage financing at preferential interest rates when they buy or construct houses. Bonds could be used as a part of the down payment when purchasing or constructing houses. There are currently two housing financing institutions: Bank Tabungan Negara (National Savings Bank) and P.T. Papan Sejahtera. In order to increase the amount of their bond issues, it may be necessary to combine these two institutions' bonds.

Public Service Bonds. Another type of bond which can be marketed are bonds issued by institutions whose services are basic to the livelihood of the people, although individual beneficiaries are often difficult to identify. A prime example is the bonds issued by P.T. Jasa Marga, the state-owned toll road authority. These bonds are backed by the revenue generated by the toll roads constructed (although to date they are not directly linked). This type of bond could also be issued by the electric company or water supply company.

The services of these institutions are essential to basic human needs and it is thus not appropriate to impose beneficiary-type bonds on the ultimate users of their services (the majority of the users are from the low- and lower-middle income group). However, electricity and water charges would provide the bond issuers with the basic cash flows to service their debt, which would provide the required protection to underwriters and investors in these bonds.

The second concern is the realistic pricing and selling of bonds. Because of the prevailing high interest rates on deposits, it would be a hardship for many issuing organizations to issue bonds at the market price. For example, if the present tax policy were to remain unchanged, coupon rates competitive with one-year time deposit rates may have to be as high as 30%. This may be higher than the cost which many potential public and private sector issuers can bear.

Despite the government's determination on the tax privileges on bonds, it may still be contended that exemptions on tax are justified for the bonds discussed above. These bonds would finance public services which cannot otherwise be financed by the budget. Their issuance not only relieves some of the burden on the treasury but also accelerates the development of the domestic capital market, which in turn promotes the self-reliance of the economy. A variety of tax privileges could be granted. Based on the nature of each public service, the degree and type of tax exemptions or relief would vary.

Some bond issuers, particularly private sector corporations, may still have to issue bonds at a price determined by the market. In order to take advantage of a possible future decline in interest rates, floating rate (variable interest rate) bonds may be considered. Floating rate bonds, however, cannot be considered as a source of long-term finance. It is necessary in this case to determine an appropriate base interest rate. A good candidate for such a base rate may be some average of the one-year state bank CD rates. If a market for government securities existed, a set spread above the equivalent government security would be ideal. In the long run a well developed bond market with a rating system to determine relative risk would be the optimal method for allowing the market to determine the price or yield for each bond issue. This in turn would require the development of a secondary market to allow bonds to sell at a premium of discount from their issue price.

Since the deregulation package of reforms was announced last December, there has been a significant increase in activity in the bond market. In the first six months of 1988, six new issues have been sold through the Jakarta exchange (see Table 1) and two more issues are being prepared. The most positive aspect of these new issues is that they include the first private sector corporate bonds and the first long-term securities issued by a leasing company.

TABLE 1: BOND ISSUES/INDONESIA, JANUARY 1988 - JUNE 1988

Company	Type	Bond Amount	Tenure	Interest Rate
P.T. Jasa Marga I	State-owned Toll Road Authority	Rp. 75 bil.	8 years	17%
Bapindo I	State-owned Development Bank	Rp. 60 bil.	5 years	17%
P.T. BBD-IBJ Leasing	Joint Venture Leasing Company	Rp. 10 bil.	3 years	18%
P.T. Astra International	Private Sector Holding Company for Local Corporate Group	Rp. 60 bil.	5 years	18.5%
P.T. Uppindo	Joint Venture Non-bank Financial Institutions	Rp. 25 bil.	5 years	17.75%
Bapindo II	State-owned Development Bank	Rp. 40 bil.	5 years	17.5%

Also pending issue in the near future are bonds from P.T. Jasa Marga, Tranche II for Rp. 35 billion and P.T. Papan Sejahtera, the state-owned housing authority, for Rp. 50 billion.

Despite the positive increase in bond activity, these recent issues have demonstrated the continuing constraints and weaknesses in the Indonesian bond market. These bond sales were not totally successful in their marketing efforts, primarily due to pricing and lack of broad-based and active participation from the institutional investor market (pension funds and insurance companies). The Jasa Marga I bond sold just 48% of the total issue during the marketing period, and only a belated commitment from Taspen to purchase the remaining Rp. 39 billion over time (by November 1988) has saved the underwriters from holding the difference in their portfolios. Likewise, the traditional overdependence on Taspen and Danareksa to purchase the majority of each bond issue has allowed the underwriters to avoid actively marketing these securities to a diversified market. Since both P.T. Taspen and P.T. Danareksa have declined to buy the bonds of either BBD-IBJ Leasing or P.T. Astra International, the underwriters are still holding 80% and 30% of each issue, respectively.

In conclusion there is considerable work to be done in the areas of bond pricing, structure and marketing (including the education of the fund managers of the various institutional investors) in order to develop this market properly in the future. These are all issues to be addressed under the Financial Markets Project through technical assistance and training.

2.1.2 Equity Market

As discussed elsewhere in this annex, the Indonesian Stock Exchange has been operating since 1977 and has evolved through a series of reforms, tax plans and deregulation policies. The latest deregulation package (December 1987) introduced a number of very positive changes designed to ease the ability to list shares and encourage trading in the secondary market. This package also established the new Bursa Paralel (parallel market), although to date no companies have listed through this new exchange.

Since the deregulation package, there has been increased activity on the exchange and the overall share price index (established in 1983) has risen significantly from 82.6 points at the end of 1987 to over 115 points by mid-May (a 40% increase). The main causes of this increase appear to be the removal of the 4% daily price limits, a general recovery in corporate performance by the listed companies, and the revised policies of P.T. Danareksa to sell shares held in its portfolio.

Despite this recent increase in activity, the Indonesian equity market remains structurally weak. The total number of companies listed on the exchange grew slowly to 24 by 1983. However, there have been no new listings since then. Additionally, many of the companies listed are joint venture firms with foreign partners. These firms originally listed a percentage of their share, not to raise equity capital, but to divest foreign ownership in order to comply with government regulations. As a result, the total capitalization (value of share listings) is only 21% of the total issued shares in these 24 companies. Not only is the supply of securities minimal in terms of the number of companies, but the supply in terms of total listed and tradeable shares (58,569,311) is also weak. Table 2 provides a schedule of the companies currently listed on the exchange, the number of shares issued, the number of shares listed, and the share ownership of Danareksa, which holds over 50% of the traded shares.

There are many factors behind the weakness and low activity level of the Indonesian equity market. Aside from the cyclical conditions currently prevailing in the economy, the causes of the severely underdeveloped state of the market may be attributed primarily to an insufficient supply of securities in the market. This in turn can be attributed to various factors which work to depress the supply of and demand for funds through the equity market.

In principle, the equity market works as any other commodity market. Higher demand for securities will push up the price of securities, which in turn stimulates the supply of more securities. The market itself can be activated by producing more attractive securities and supplying them to the market.

The present condition of the Indonesian equity market may have originated partly from the lack of understanding of the nature of equity capital by the general public and partially from the desire of the government to protect the public from losses. One of the original goals in the establishment of Danareksa was to offer a guaranteed return to its certificate holders and to intervene in the market to protect price levels. Equity investors in Indonesia have been over-protected and deprived of the chance to make financial gains, which is the core of this market's attractiveness. In order for the market to supply the equity capital that is essential to the development of the corporate sector, it is crucial to establish investors' understanding of the fact that equity capital is risk capital.

Equity capital ultimately absorbs the risks involved in corporate activities. However, because of it, lenders (notably bankers and bond holders) can extend financing. Equity is in this sense collateral or security for receiving debt financing. Lenders should hesitate to make loans or purchase bonds if the debt/equity ratio of the company is too high. Equity works as a cushion to protect debt holders by absorbing negative shocks when the economy sags and company revenues shrink.

TABLE 2: THE INDONESIAN EQUITY MARKET

COMPANY LISTED ON EXCHANGE	NUMBER OF SHARES ISSUED	NUMBER OF SHARES LISTED	SHARES OWNED BY PT. DANAREKSA: NUMBER OF SHARES	% OF TOTAL ISSUED	% OF TOTAL LISTED	SHARES OWNED BY THE OTHERS: NUMBER OF SHARES	% OF TOTAL ISSUED	% OF TOTAL LISTED
. SEMEN CIBINONG	9.150.000	557.096	360.127	3,94%	64,64%	196.969	2,15%	35,36%
. C E N T E X	2.768.000	700.000	103.000	3,72%	14,71%	597.000	21,57%	85,29%
B A T. IND.	22.000.000	6.600.000	4.855.350	22,07%	73,57%	1.744.650	7,93%	26,43%
TIFICORP IND.	6.200.000	1.100.000	881.650	14,22%	80,15%	218.350	3,52%	19,85%
R V I	1.451.670	420.000	202.449	13,95%	48,20%	217.551	14,99%	51,80%
GOODYEAR IND.	41.000.000	6.150.006	3.622.900	8,84%	58,91%	2.527.106	6,16%	41,09%
MERCK IND.	5.600.000	1.680.000	831.850	14,85%	49,51%	848.150	15,15%	50,49%
. MULTI BINTANG	21.070.000	3.520.012	1.728.965	8,21%	49,12%	1.791.047	8,50%	50,88%
. UNILEVER IND.	61.300.000	9.200.000	5.325.555	8,69%	57,89%	3.874.445	6,32%	42,11%
. SEPATU BATA	13.000.000	1.950.000	621.915	4,78%	31,89%	1.328.085	10,22%	68,11%
. U N I T E X	5.667.500	733.500	348.000	6,14%	47,44%	385.500	6,80%	52,56%
. S U C A C O	16.000.000	4.800.000	1.307.550	8,17%	27,24%	3.492.450	21,83%	72,76%
. BAYER IND.	7.747.000	2.324.100	1.327.550	17,14%	57,12%	996.550	12,86%	42,88%
. PANIN BANK	16.000.000	4.800.000	1.811.675	11,32%	37,74%	2.988.325	18,68%	62,26%
. SQUIBB IND.	3.240.000	972.000	361.750	11,17%	37,22%	610.250	18,83%	62,78%
. A J P P	2.000.000	1.020.000	275.200	13,76%	26,98%	744.800	37,24%	73,02%
. SARI HUSADA	4.992.000	1.257.720	104.000	2,08%	8,27%	1.153.720	23,11%	91,73%
. PAN UNION INS.	1.500.000	765.000	192.200	12,81%	25,12%	572.800	38,19%	74,88%
. REGNIS IND.	7.971.707	523.500	261.750	3,28%	50,00%	261.750	3,28%	50,00%
. PFIZER IND.	3.000.000	600.000	120.000	4,00%	20,00%	480.000	16,00%	80,00%
. DELTA DJAKARTA	3.890.000	390.807	112.056	2,88%	28,67%	278.751	7,16%	71,33%
. HOTEL PRAPATAN	8.325.896	1.665.976	418.000	5,02%	25,09%	1.247.976	14,99%	74,91%
JAKARTA INT.HTL	15.750.000	6.618.600	4.646.650	29,50%	70,21%	1.971.950	12,52%	29,79%
P R O D E N T A	1.104.000	221.000	33.150	3,00%	15,00%	187.850	17,02%	85,00%
T O T A L	208.720.643	58.569.311	29.853.292	10,63%	50,97%	28.716.019	10,23%	49,03%

COMPANY LISTED ON EXCHANGE	VOLUME OF SHARES TRADING: 1986	1987	CASH DIVIDEND PER SHARE: 1986 *)	1987	TOTAL Rp. DIVIDEND PAID: 1986 *)	1987 *)	1987 SHARE TRADE VOLUME BY PT. DANAREKSA: BOUGHT	SOLD	BY OTHERS: BOUGHT	S
. SEMEN CIBINONG	14.868	10.984	-	1.000	-	557.096.000	8.029	200	2.955	1
. C E N T E X	11.770	217.240	-	750	-	525.000.000	-	-	217.240	21
B A T. IND.	364.240	166.150	130	135	858.000.000	891.000.000	-	-	166.150	16
TIFICORP IND.	21.550	22.940	1.000	625	1.100.000.000	687.500.000	14.900	400	8.040	2
R V I	14.172	14.025	1.130	1.450	474.600.000	609.000.000	-	-	14.025	14
GOODYEAR IND.	240.900	146.150	-	-	-	-	13.600	-	132.550	146
MERCK IND.	19.575	16.100	320	240	537.600.000	403.200.000	-	-	16.100	16
. MULTI BINTANG	54.510	83.202	230	230	809.602.760	809.602.760	-	-	83.202	83
. UNILEVER IND.	181.045	134.300	380	450	3.496.000.000	4.140.000.000	1.000	650	133.300	133
. SEPATU BATA	47.995	267.878	339	275	661.050.000	536.250.000	-	-	267.878	267
. U N I T E X	11.150	64.150	100	180	73.350.000	132.030.000	20.100	2.100	44.050	62
. S U C A C O	114.650	351.300	80	140	384.000.000	672.000.000	-	-	351.300	351
. BAYER IND.	66.700	63.150	70	180	162.687.000	418.338.000	-	-	63.150	63
. PANIN BANK	95.200	388.900	414	204	1.987.200.000	979.200.000	51.300	-	337.600	388
. SQUIBB IND.	34.750	34.900	190	210	184.680.000	204.120.000	-	100	34.900	34
. A J P P	250	2.350	400	400	408.000.000	408.000.000	-	-	2.350	2
. SARI HUSADA	10.186	418.493	210	225	264.121.200	282.987.000	-	-	418.493	418
. PAN UNION INS.	3.100	4.750	151	151	115.515.000	115.515.000	-	-	4.750	4
. REGNIS IND.	4.050	3.750	-	-	-	-	-	-	3.750	3
. PFIZER IND.	33.350	18.650	315	227	189.000.000	135.900.000	-	-	18.650	18
. DELTA DJAKARTA	12.260	4.312	-	-	-	-	-	-	4.312	4
. HOTEL PRAPATAN	19.200	3.200	-	-	-	-	-	-	3.200	3
JAKARTA INT.HTL	53.600	80.400	120	270	794.232.000	1.787.022.000	34.000	8.100	46.400	72
P R O D E N T A	2.850	6.400	223	260	49.380.240	57.460.000	-	-	6.400	6
T O T A L	1.431.921	2.523.674	5.802	7.602	12.549.018.200	14.351.220.760	142.929	11.550	2.380.745	2.512

NOTE : *) Based on payment date.

Because of the risk nature of equity capital, the company can grow. If there is no risk capital available to entrepreneurs, they cannot initiate new business ventures which, although characteristically risky, may yield high returns in the end. Without risk capital, venture capital would not invest in potentially successful new companies and they in turn would not be able to grow. The equity market accepts such risk capital and provides entrepreneurs with it. A new company or even an established one which cannot secure enough risk capital internally should be able to issue shares through the equity market and raise such funds. Through the equity market these companies can grow. Growth momentum of private enterprise is one of the leading sources of private sector growth, and hence of growth in the economy.

Equity investors should also be well informed about market characteristics. While there is a chance that equity capital will grow and investors will realize capital gains, there is also a chance of suffering a loss on the investment because of declining business or company failures. In this sense, equity investments offer a high expected return and high risk. Denying the risk nature of equity capital, however, is denying equity capital itself, hence denying the base of the free enterprise system. Therefore, if private individual investors with small financial resources are encouraged to invest in equity, they have to be throughly educated about the nature of equity.

In Indonesia, private investors tend to regard equity investment as similar to depositing money with banks. Hence, they demand high dividend yields to compete with interest income from short-term bank deposits. This attitude is due to a lack of understanding of the nature of equity capital and the fact that excessive dividend payments may cause a deterioration in the financial condition of the company, thereby undermining their own investment. Additionally, under present conditions and government regulations, the chances of making a capital gain on an equity investment are limited.

Another structural constraint to the growth of the equity markets in Indonesia is the argument often put forward by government authorities (including officials who manage the exchange operations) that speculation in the stock market is not desirable. This philosophy is based on the deep concern that intensive speculative moves in equity investment will eventually lead to a collapse of the market, jeopardizing many small investors. Speculation, by definition, is an act of taking business risk in the hope of gain. Hence, investing in a company with the hope that the company will grow and realize high returns is considered to be speculating.

Even though there is ample evidence of a strong demand for equity capital or an equivalent potential supply of securities, the number of companies listed on the stock exchange in Jakarta has remained constant for the past four years. This phenomenon can be partially attributed to the current policy imposed on the listed companies to pay high dividends and the limited scope for capital gains on equity investment due to the constraints placed on company growth.

Historically, several companies listed on the Indonesian stock exchange have actually paid out dividends greater than their annual earnings. In all cases, the dividend pay-out ratio has been excessive if not actually suicidal. Table 3 lists the after tax earnings and dividend payments made by the 24 traded companies in the last two years.

This excessive dividend policy has been adopted by many companies primarily because of the attitude and demands of stock investors. Investors consider the 18-20% interest paid on time deposits with tax exempt privileges to be more attractive than the average 15% nominal dividend return paid on stocks. This reflects the limited opportunities to realize capital gains on investments in Indonesia. Companies maintain this policy in order to keep their shares attractive and not to subject themselves to unwarranted public criticism. This practice financially burdens the companies and makes the listing of additional shares uninteresting for them. The impact of this policy is to turn equity capital into another form of debt.

This deterioration of corporate strength undermines the interest of creditors and equity investors alike. A creditor's security interest in the asset value of the company decreases since high dividend payout ratios imply that equity holders make claims on assets on which the creditors normally have a higher priority. High dividend payout ratios may also reduce the interest of equity investors themselves, as it reduces the shareholders' capital which is normally used for future company expansion or saved as insurance against future possible losses. This weakens the financial soundness of the company and reduces its resilience against future adverse conditions. It also may deprive equity investors of an opportunity to realize capital gains on their investment since a company's capacity for expansion and growth decrease as its retained earnings are reduced.

It is essential that there be a basic shift in corporate policy regarding dividend payments. This must be combined with an equally fundamental change in the "short-term, immediate return and high yield" philosophy of equity investors who must accept the risks of a long-term market and seek returns based primarily on a combination of capital gains and dividend payments, as opposed to just dividend payments.

Another major constraint which affects the growth of an equity market in Indonesia is the very limited scope for capital gains. This makes equity investment unattractive as a long-term investment and increases the cost of equity capital for companies which obtain long-term funds through such a market.

The potential for making capital gains is limited in Indonesia primarily because of the restrictive regulations and licensing requirements placed upon corporate expansion. Capital gains can be realized mainly when companies grow and prosper, and the growth of companies is generally inseparable from the expansion of their production or service rendering capacity. Thus, the rules restraining expansion by companies limit the scope of company growth. In order for the stock

TABLE 3: SCHEDULE OF DIVIDEND PAYMENTS, COMPANY PROFILES, 1986 AND 1987 (IN MILLION RP.)

COMPANY NAME	REPORTED NET PROFIT AFTER TAX 1986 Rp.	DIVIDENDS PAID 1986 Rp.	PAY OUT RATIO 1986 %	REPORTED NET PROFIT AFTER TAX 1987 Rp.	DIVIDENDS PAID 1987 Rp.	PAY OUT RATIO 1987 %	DIVIDENDS PAID 1ST SEMESTER 1988 (Rp./SHARE)	DIVIDENDS DECLARED AND UNPAID 1988 (Rp./SHARE)
PT. SEMEN CIBINONG	2,285	0	0.00%	6,398	3,575	55.88%	278.50	--
PT. C E N T E X	(117)	0	0.00%	4,159	0	0.00%	--	--
PT. B A T INDONESIA	2,981	2,200	73.80%	4,630	3,410	73.65%	1,023.00	--
PT. TIFICO	5,202	6,200	119.18%	15,260	7,750	50.79%	687.50	--
PT. RICHARDSON VICKS IND.	1,754	1,442	82.21%	2,391	2,030	84.90%	546.00	--
PT. GOODYEAR INDONESIA	(2,037)	0	0.00%	5,202	0	0.00%	--	--
PT. MERCK INDONESIA	1,529	1,152	75.34%	2,974	2,800	94.15%	537.60	--
PT. MULTI BINTANG INDONESIA	5,614	4,486	79.91%	8,863	4,486	50.61%	809.60	--
PT. UNILEVER INDONESIA	31,248	30,037	96.12%	31,518	30,334	96.24%	3,082.00	--
PT. SEPATU BATA	4,708	3,362	71.41%	3,513	3,575	101.76%	360.75	--
PT. UNITEX	525	367	69.90%	1,740	660	37.93%	88.02	--
PT. SUCACO	3,862	1,280	33.14%	5,139	2,240	43.59%	528.00	--
PT. BAYER INDONESIA	2,706	418	15.45%	2,128	418	19.64%	255.65	--
PT. PANIN BANK	7,064	6,624	93.77%	8,218	3,264	39.72%	1,104.00	--
PT. SQUIBB INDONESIA	1,125	528	46.93%	1,170	885	75.64%	204.12	--
PT. ASURANSI JIWA PANIN PUTRA	907	650	71.66%	933	800	85.74%	--	428.40
PT. SARI HUSADA	1,907	998	52.33%	1,521	1,249	82.12%	119.83	--
PT. PAN UNION INSURANCE	260	226	86.92%	327	226	69.11%	--	137.70
PT. REGNIS	(2,351)	0	0.00%	(596)	0	0.00%	--	--
PT. PFIZER INDONESIA	427	216	50.59%	775	156	20.13%	117.90	--
PT. DELTA DJAKARTA	(821)	0	0.00%	1,168	0	0.00%	--	--
PT. HOTEL PRAPATAN	(46)	0	0.00%	444	0	0.00%	--	--
PT. JAKARTA INT'L HOTEL	4,268	4,016	94.10%	7,472	4,016	53.75%	794.23	1,025.88
PT. PRODENTA	338	533	157.69%	340	287	84.41%	--	--
AVERAGE	3,056	2,697	88.25%	4,820	3,007	62.39%	--	--

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market to become truly attractive to both investors and equity issuers and to function as an efficient marketplace for providing necessary capital for private sector enterprises, there need to be improved opportunities for companies to expand their capacity more freely.

It normally takes 30 days for a company to obtain a license for listing on the stock exchange, from the date of submission of a letter of intent to Bapepam (the Capital Market Executive Agency which acts as market regulator as well as operator). This is a positive improvement from the previous 90 day timeframe in effect before the 1987 reforms.

However, the company is also required to obtain approvals from various government offices such as the Ministry of Justice, the Director General of Taxes, and the Investment Coordinating Board (BKPM) before Bapepam can start the review process. This pre-Bapepam procedure normally takes another three months. In addition, companies usually have to have their assets reevaluated by appraisers before they submit the application forms. This could add another two months to the entire process and significantly increase pre-issue costs.

Approval by Bapepam includes a review of the issuing price, reports by the company appraisers and an analysis of the "future prospects" of the company. Bapepam not only reviews the documents submitted, but often makes estimations and appraisals itself. This practice reflects the underdeveloped stage of the securities industry and the workings of an established government bureaucracy. These activities are best left to the underwriters, appraisers, and auditors. Bapepam should limit itself to the review of the submitted prospectus, acting as a regulatory agency for the exchange only, and allow the marketplace to determine the actual value and attractiveness of a particular issue.

BKPM's review of a company's expansion program should be substantially shortened or removed altogether. In particular, company expansion is one of the most important reasons why many companies decide to list their shares on the exchange. This is also a major reason for capital gains on equity. Hence, if companies can grow more freely or if a liberal expansion policy is adopted, it would stimulate the supply of securities to the market. The value of equity capital in the market is highly related to the strength and growth potential of a company. A company may regard it as desirable to raise the necessary funds for expansion through equity capital, if it can freely expand its capacity. Furthermore, growing companies are more attractive to equity investors; hence, they create an increased demand for equity investment. In this regard, the government should consider further deregulation of the investment licensing system.

Last, the equity market is suffering due to the attitudes within the Indonesian business community itself. These attitudes reflect reactions to various economic restrictions as well as traditional business practices. Many potential investors with sizable investible funds consider investing in equity capital as less attractive than utilizing the funds for their own businesses, particularly in the trade or real estate sectors. It is not unusual for small-scale businesses in these sectors to realize a return as high as 30-40% a year. For many investors, to invest funds in undertakings which are normally closely guarded among a family-controlled group gives better security, stronger control, and higher returns than investing in equity stocks. Many such owners consider going public to be a nuisance because going public requires public disclosure of their financial condition and would open their tax liability to additional scrutiny. This attitude seems to be widespread even among the large, established enterprise owners. It will require substantial effort on the part of the government to educate and convince these entrepreneurs that there is an advantage to raising equity on the capital market. The FMP's support for promotional campaigns will be directed specifically at this need.

2.1.3 Financial Sector/Lending Market

The primary institutions involved in the financial sector are the five state-owned commercial banks, private commercial banks, state development banks (primarily Bapindo), savings banks, the 14 non-bank financial institutions, leasing companies, and Bank Indonesia. The lending conditions and funding sources for each of these institutions are different.

Indonesia's financial sector has been characterized by government led development policy since the beginning of the "New Order" government, and the massive infusion of foreign exchange created by oil sector revenues during the 1970s. In practice, the existence of this substantial oil surplus literally deprived the financial sector of any real incentive to strengthen the domestic capital market.

Bank Indonesia dominates the entire financial system. The central bank not only implements monetary policy but also extends credit to the various economic sectors directly and indirectly. The sources of funds are derived from government deposits, which are basically the public sector surplus created by oil export revenues. The total assets of Bank Indonesia accounted for almost 40% of the sector's total assets in 1987.

The five state commerical banks and Bapindo have also played a dominant role in this sector. The assets of these six banks accounted for 45% of the financial sector's total assets in 1987. When only deposit taking banks are considered, they accounted for 71% of total assets, 66% of total deposits, and 72% of total lendings in 1987.

Long-term credit is a small part of total credit and is concentrated in the state banks. Except for oil surplus funds, there have been no significant sources of long-term funds in Indonesia. Hence, the long-term loans have been almost exclusively extended by the state commerical banks which utilized the Bank Indonesia refinancing facility or liquidiy credits. Bapindo, which has access to foreign exchange loans from multi-national and bilateral sources, also extends some term financings. National private banks can extend long-term loans utilizing government sponsored investment credits from the small-scale industries

(KIK) program. In addition, since January 1984, national private banks have been allowed to extend credits with maturities over one year. However, they still are not active in long-term lending activities in any significant way.

The role of non-bank financial institutions has been quite small despite the government's original intention to develop them. Their development has been neglected primarily due to the ready availability of oil surplus funds in the economy, and they have not been given the opportunity nor been required to function as genuinely long-term financing institutions. They also suffer from a lack of long-term funding sources.

The financial market in Indonesia lacks a truly developed money market. The interbank call and deposit markets have been active recently, but transactions are all direct transactions between banks. There are no specialized money market dealers or discount houses. This severely impedes the smooth development of a secondary market.

Table 4 lists the 1987 asset base and market share of the financial institutions in Indonesia.

TABLE 4: ASSETS OF FINANCIAL INSTITUTIONS, AS OF 3/3/1987

	Institutions	Assets (Rp Trillion)	Share (Percent)
(1)	Central Bank	28.6	38.4
(2)	Commercial Banks:	40.2	
	State Commercial Banks	29.5	55.6
	Private National Commercial Banks	8.1	
	Foreign Banks/Joint Ventures	2.6	
(3)	Development Banks:	1.2	1.8
	State Development Banks	.86	
	Local & Private Development Banks	.34	
(4)	Savings Banks:	.73	.9
	State Savings Banks	.68	
	Private Savings Banks	.05	
(5)	Non bank Financial Institutions:	1.72	.2
	Development Financial Institutions	.60	
	Investment Financial Institutions	1.12	
(6)	Leasing Companies	.92	1.2
	Total:	73.37	98.1

Source: Bank Indonesia Financial Statistics.

Table 5 indicates the percent of the total assets loans and funds by type of bank. As can be readily seen, the five state commercial banks dominate the banking sector.

TABLE 5: ASSETS, LOANS AND FUNDS BY TYPE OF BANK, AS OF MARCH 1987

Type of Bank	Assets %	Loans %	Funds %
State Banks	71.3	71.7	66.0
National Private Banks	19.5	21.0	22.8
Local Development Banks	3.0	2.9	2.9
Foreign Banks	6.2	4.4	8.3
Total	100	100	100

State-Owned Commercial Banks. The sources of funds for the state banks are mainly demand deposits, time deposits, liquidity credits and long-term investment funds from Bank Indonesia. Demand deposits comprise 35-65% of the total deposits at state banks. When customers meet certain minimum balance requirements, the banks pay about 6% interest on demand deposits. Time deposit maturities range from one to 24 months. Since the deregulation of interest rates in 1983, the state banks have increased the interest rates paid on their time deposits substantially, to 18-19% per annum from the previous level of 9%. As a result, time deposits with state commercial banks have grown rapidly since June 1983. The outstanding amount at the end of 1986 was Rp. 6,574 billion. These banks also issue certificates of deposit (CD). In theory, they are negotiable, but due to the lack of established trading of negotiable securities, there is virtually no secondary market. The state commercial banks used to depend on Bank Indonesia's refinancing facility as a major source of funds. Since June 1983, the outstanding amount of the liquidity credits from the central bank has not increased substantially. However, it still represented nearly 30% of the total funds for these banks as of year end 1986.

The state commercial banks have the largest demand and time deposit bases. However, if they are required to finance long-term corporate investment activities, either through extending long-term loans or investing in bonds, they will have to strengthen their long-term funding. Their long-term funding strategy will have to meet the following requirements: First, it should attempt to shift present depositors towards longer-term maturities, and to cultivate new private individual and institutional depositors. Second, in order to make long-term savings attractive to many savers, the savings instrument should have a fairly high degree of liquidity like (e.g., negotiable

CDs). Third, the savings instrument should resemble a bond, such as a floating rate note, that is easily understood and can be traded in the market.

Currently, a substantial proportion of commercial bank deposits is in demand deposits, on which banks pay 6-8% interest if certain conditions, such as the maintenance of a minimum balance, are met. If these low-cost funds are mixed with funds from other sources, such as time deposits, the overall cost of funds from deposit-taking operations will be much lower than the direct time deposit costs. The state banks' dependency on demand deposits is particularly high, as shown Table 6.

TABLE 6: SHARE OF DEMAND DEPOSITS IN TOTAL DEPOSITS, AS OF MARCH 3, 1987

	Demand Deposits %	Time, Savings and CD Deposits %	Total %
State Banks	48.6	51.4	100.0
Private Banks	36.8	63.2	100.0

Source: Bank Indonesia.

The resource base of these banks in terms of either total assets or deposit base is quite substantial. In 1987, they accounted for 71% of the total assets of the financial sector, and 66% of the total deposits of the deposit-taking banks. They can often meet the capital requirements of large scale investment projects by themselves. Their size alone should act as insurance against various macroeconomic, financial, and business risks to which their loans are exposed. Their size also allows them to mobilize a large amount of funds at a much lower cost than smaller banks, mainly because they enjoy economies of scale. This is primarily due to the fact that administrative costs per unit of funds mobilized decline as the size of the bank increases, even though the actual cost of funds may remain the same.

Despite their dominant strength and size within the financial sector, the state banks continue to lend most of their funds on a short-term basis and only extend term credit to other state enterprises when funded directly for that purpose by Bank Indonesia. The World Bank reports that less than 40% of the credits extended by the financial system have an original maturity beyond 12 months. There is a genuine concern by the management of these banks against extending term credit since their deposit base is so heavily weighted towards the short term. This base must be shifted, particularly if, as is the announced policy, there is to be less dependence upon Bank Indonesia liquidity credits.

While there is genuine concern with regard to the management of sources and uses of funds in the banking sector, it is worth recalling that commercial banks in other countries extend long-term loans, even though their funding base remains short term. Protection against possible shortfalls in funding or adverse changes in interest rates when this kind of term mismatching exists is normally provided through: 1) a large resource base of individual banks, and careful management of their assets and liabilities; 2) an efficient interbank money market; and 3) a facility through which the central bank acts as a lender of last resort. Because of these large banks' resource base, it should be possible to establish such a structure if asset and liability management are carefully and adequately undertaken.

Private Commercial Banks. Of Indonesia's 65 national private commercial banks, 10 are permitted to trade in foreign exchange and are classified as national private foreign exchange banks. Most of the others are small local banks which act as captive financial companies for their shareholder groups. The sources and uses of private commercial bank funds are essentially the same as those of the state banks. Borrowings from the central bank are available to the private banks, but because of the cumbersome procedures involved, they are not utilized as widely. Their landing activities concentrate on short-term loans (usually to related companies) with one to six month maturities.

Eleven foreign banks operate branches in Jakarta. In addition, there is one joint venture bank, which was given a license to operate before 1960. (At the end of 1960, the GOI decided to invite foreign banks to operate in Indonesia in order to promote the general policy of opening the country to foreign investment, to promote the inflow of foreign capital, and to benefit from the technological transfer of modern banking practices.) No new permits, however, have been granted since 1970. In order not to impede the development of the domestic banking sector, foreign banks are allowed to operate only within certain parameters. They can open only one main branch office and one sub-branch office within Jakarta. While their business activities are limited to inside Jakarta, they can extend loans outside Jakarta if done jointly with domestic banks. Their major activities are extending working capital credits, mostly to foreign joint venture companies. They must also obtain a permit from Bank Indonesia before extending investment credits for a period of longer than one year.

State Development Banks. There is one state development bank (Bapindo), 27 regional development banks, and one private development bank. All but Bapindo are quite small. Bapindo borrows from Bank Indonesia, the government, and multilateral and bilateral foreign sources (see Table 7). Its deposit base is actually quite small. Bapindo's total outstanding borrowings were Rp. 725.1 billion at the end of 1986. Bapindo extends long-term investment loans, working capital loans, government sponsored small-scale industry investment and working capital loans (KIK and KMKP), and equity participation.

TABLE 7: BAPINDO--SOURCE OF FUNDS, 1984 - 1986
(Rp. billion)

	1985	1986
Capital and Retained Earnings	190.9	269.9
Long-term Borrowings	663.5	725.1
Bank Indonesia	535.6	593.3
Other State Banks	10.1	9.2
Government	.71	13.2
Foreign	117.1	109.4
Demand and Time Deposits	162.7	234.4
Total	1,017.1	1,229.4

Source: BAPINDO, Annual Report 1986.

Savings Banks. There is one national savings bank (Bank Tabungan Negara, BTN) and two small private savings banks. They collect small deposits from private individuals, mostly in the form of Tabanas/Taska, a government sponsored savings scheme. BTN accounts for about 10% of the total Tabanas/Taska accounts, the total outstanding amount of which was Rp. 1,286 billion at the end of 1986. These funds are utilized mostly to finance low-income housing. However, because such savings are limited in amount and cannot meet the necessary housing financing requirements, the government (through Bank Indonesia) provides most of the funds. The outstanding amount of BTN housing finance in March 1987 was Rp. 1,391 billion, extended to both private individuals and public developers.

Non-bank Financial Institutions (NBFIs). The 14 NBFIs operating in Indonesia were formed in 1973-1974 to act as intermediaries for long-term funds. However, due to various constraints, they are not working as was expected. Their activities are outside the realm of the banking law and none of them are allowed to take deposits.

NBFIs are classified into two types: development-type financial institutions and investment-type financial institutions. Development finance companies are to provide long-term loans and equity finance. Investment finance companies are to function as investment banks or securities companies. A 1983 Ministry of Finance decree stated that commercial banks can also underwrite and deal in securities. Hence, investment finance companies compete with the commercial banks which have a stronger resource base and a wider branch network.

There are three development-type financial institutions operating in Indonesia, P.T. Private Development Finance Company (PDFCI), P.T. Indonesia Development Finance Company (IDFC), and P.T. Bahana. PDFCI and

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IDFC provide mainly long-term loans to public sector enterprises. Bank Indonesia is a share owner in both institutions. Their source of funds consists mainly of borrowings from banks and other NBFIs on a short-term basis, and from Bank Indonesia, foreign partners, and international lending agencies on a long-term basis. The majority of their loans are medium- to long-term loans with maturities ranging from three to seven years. P.T. Bahana is a venture capital finance institution owned by the government and Bank Indonesia. It was formed in 1973 to provide equity and loan finance together with management assistance for small private enterprises so that they can become creditworthy enough for commercial bank borrowings.

The nine investment-type financial institutions were established in 1973-74 to provide long-term funding. Bank Indonesia has an equity participation in one of them and the five state commercial banks are joint venture partners in the others. Most of them are joint venture companies between Indonesian partners and various foreign merchant or investment banks. They are allowed to conduct business in securities trading and act as financial intermediaries. Their main areas of business are supposed to be: underwriting bond and equity issues; dealing in securities and commercial paper; acting as a trustee; providing short- and long-term debt finance; and providing equity finance. In practice, however, the NBFIs have concentrated their activities in trading short-term promissory notes among their customers, thus providing both a source and a use of funds. There is no secondary market trading of this paper. These institutions deal mostly within the interbank and call money market, with only an occasional transaction as a bond underwriter or trustee.

Over the years these institutions, which should be one of the main engines for capital market development, have in fact moved away from this role for two reasons. First, their base of funding has remained very short term which compromises their ability to invest in long-term assets. Second, they tend to cite the lack of development of the capital market itself as a reason not to be involved in what appears to be a risky and marginally profitable area of business. Nonetheless, the NBFIs remain an important element for future capital market development and as such should receive assistance to become risk takers and underwriters.

Leasing Companies. The leasing business in Indonesia started in 1974 and has grown very rapidly since the banking deregulations of 1983. Currently, 83 leasing companies operate in Indonesia, of which 35 are joint venture companies, one is a state-owned company, and 47 are domestic companies. They are to provide financial leases mostly for industrial machinery, construction machinery, automobiles, and office equipment. It is estimated that the outstanding lease contracts totalled some Rp. 920 billion as of year end 1987. These companies depend on borrowings from banks and foreign sources to finance their leasing activities. The industry is dominated by 10 to 12 large companies whose predominant source of business has been the state enterprises, particularly the oil industry. However, the growth of the leasing business itself is a positive indicator of the strong demand for capital in Indonesia.

Bank Indonesia. Bank Indonesia is the central bank of Indonesia, whose legal entity is based on the Central Bank Act of 1968. Bank Indonesia also 1) extends credits to banks, which are known as liquidity credits, and direct credits to state enterprises and 2) controls the banking system, through its foreign exchange and discount windows, as well as the liquidity of the banks themselves, through statutory reserve requirements. The role of Bank Indonesia and the mechanics of the money market are an integral part of the Indonesian financial sector; a more detailed analysis of them is presented in Section 3 of this Annex.

2.2 SUPPLY OF CAPITAL

The supply of capital to meet short-term demand is sufficient. The primary problem is accessing the supply of long-term capital from pension funds, insurance companies and savings accounts. The ability of any financial system to provide an adequate supply of capital is dependent upon the alternative uses for these monies. In Indonesia, several basic factors cause capital to avoid the long-term market.

High present interest rates hurt the bond and equity markets and inhibit corporate capital investment. Many people in the business circle argue for lower interest rates. This, however, is not an easy solution for Indonesia under present circumstances. Indonesia is a capital deficient country, and the present high interest rates reflect the fear of capital flight, the current account deficit, the inflation rate, and a pervasive fear of currency devaluation.

The supply of funds for the capital market is also negatively affected by the unequal tax treatment for securities investments. Interest income earned on bank deposits is currently tax free through an exception in the tax law granted by the Ministry of Finance. Dividend income, capital gains and interest on bonds are fully taxable at up to a maximum of 35%. It is basic to the future of capital market development that these two disincentives be addressed by the authorities and corrective measures taken.

From the position of the bond and stock markets today, Table 8 provides some indication of the sources (supply side) of investment funds.

TABLE 8: MARKET POSITION, 30 JUNE 1988

(Rp. billions)

Supply of Capital Invested	Bond Market Rp.	% of Total	Stock Market Rp.	% of Total
P.T. Danareksa	225.9	22	80.1	51
State-owned Pension and Insurance Funds	749.7	73	47.1	30
Other Institutional Investors	41.1	4	23.5	15
Individuals	10.3	1	6.3	4
Total:	1,027	100	157	100

The role of Danareksa is analyzed in detail Section 5 of this Annex. The other two readily identifiable sources of capital in Indonesia are the various pension funds and insurance companies.

2.2.1 Insurance Companies

Three distinct types of insurance companies operate in Indonesia: life insurance companies, indemnity insurance companies, and social insurance companies which include the social security and government worker welfare systems. Reinsurance companies also operate in Indonesia. The latest data for the financial position of these companies (as a group) are presented in Table 9.

TABLE 9: FINANCIAL CONDITION OF INDONESIAN INSURANCE COMPANIES
(Rp. billion)

	1985	1986
(a) Non-life Insurance & Reinsurance Companies		
Current Assets	230.316	256.802
Investments	343.395	391.791
Statutory and other deposits	293.223	351.518
Other investments	50.172	40.273
Fixed Assets	35.231	35.967
Other Assets	85.382	63.612
Liabilities	497.111	471.190
Current liabilities	285.971	232.251
Technical reserves	200.519	237.882
Capital	251.114	298.404
(b) Life Insurance Companies		
Current Assets	84.804	91.526
Investment	278.918	413.054
Bonds	12.744	28.013
Shares	32.621	38.042
Real estate	6.931	5.529
Deposits	142.312	226.425
Policy loan	60.583	84.399
Mortgage	23.227	30.646
Fixed Assets	44.885	61.855
Liabilities	379.639	536.320
Technical Reserve and Capital	352.224	500.286
(c) Social Insurance Companies 1/		
Current Assets	47.642	64.963
Fixed Assets	24.603	62.032
Investment Funds	966.436	1.207.979

Source : Ministry of Finance

1/ Includes : PT. TASPEN,
PERUM ASTEK,
PERUM ASABRI, and
PT. AK. JASA RAHARJA.

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Of the 108 insurance companies operating in Indonesia, 77 provide indemnity insurance, 23 provide life insurance, five provide social insurance, and three are reinsurance companies. As can be seen in Table 9, the funds mobilized by these companies are primarily invested in bank deposits. About 90% of the investable funds of risk insurance companies are placed in deposits and only 10% are classified as other investments, which includes shares and bonds. In fact, this figure has actually declined from 1985 levels. The life insurance companies report 7% and 9.% of their total investments in bonds and shares, respectively, while 55% are placed in bank deposits.

Of the five social insurance companies, the predominant ones are for army veterans and government employees. Taspen holds the largest percentage of these funds as a workers' compensation fund and separately manages the government employees' pension fund. A detailed schedule of the actual investments of these funds is not available. Data from both Taspen and Astek, however, indicate that total investable funds from these two companies alone exceed Rp. 1.2 trillion and that less than 10% of this total is invested in capital market instruments, mostly bonds. Both companies have publicly stated that their investment philosophy is to place most of their funds in state bank deposits for "maximum safety guaranteed by the Central Bank with tax exempt monthly interest." It is estimated that as of year end 1987, Astek and Taspen (insurance scheme only) had invested approximately Rp. 113 billion in either shares, Danareksa certificates or bond issues.

Considerable educational effort will be necessary to alter this investment profile and to train the financial managers of these companies in proper investment procedures as regards matching their long-term liabilities with long-term assets. Obvious structural changes will also need to be implemented to sway insurance funds away from high-yielding bank deposits.

2.2.2 Pension Funds

Well over 300 privately established pension funds are operating in Indonesia. Additionally, most public enterprises have created subsidiary companies or associations (yayasan) which manage sizeable pension portfolios, adding another 150 to 200 funds to the total. These pension funds are currently unregulated (a pension fund law has been under consideration for over three years) and reliable data are difficult to obtain.

A Ministry of Finance survey provides a sample profile. Not including Taspen, which manages the government employees' pension fund, 43 of the larger funds reported total investment funds of Rp. 1,091 billion as of 31 December 1986. Extrapolating from these figures and considering the growth during 1987, it is estimated that total investable funds in private and public pension funds could be as high as Rp. 4,500 billion. Taspen reports it managed Rp. 2,198 billion as of 31 December

1987, or 49% of the estimated total. There is a danger of double counting, however, as part of Taspen's portfolio is also considered in the figures for social insurance companies.

Taspen was established in 1963 to provide pension funds, labor insurance (workmen's compensation) and a provident fund for civil servants. The company collects slightly more than 8% of the monthly salary of over 3.6 million civil servants in Indonesia. Workmen's compensation participants now total approximately 160,000 employees of state enterprises. For year end 1987, P.T. Taspen reported the following pension fund investment figures:

	Amount	% of Total
Bank Deposits	1,327	60.4
Bonds	511	23.3
Shares and Danareksa Certificates	299	13.6
Bank Indonesia SBI	56	2.5
Real Estate	5	0.2
Total (Rp. billion)	Rp. 2,198	100%

Tables 10, 11 and 12 profile the 43 funds for which the Ministry of Finance has provided data on both a combined and an individual basis.

TABLE 10: SAMPLE OF 43 PENSION FUNDS: COMBINED 1986 FINANCIAL PROFILE
(Rp. billion)

	Amount	% of Total
Time Deposits	751,031	68.8
Shares	73,962	6.8
Bonds	69,055	6.3
Real Estate	111,624	10.3
Promissory Notes	5,267	0.5
Other Equities	80,099	7.3
Total Investment Funds	1,091,038	100%

It must be emphasized that the figures presented in Table 10, when combined with reported amounts from Taspen, are estimates. However, the investment profile is considered correct for the entire industry.

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TABLE 11: INDONESIAN PENSION FUND ASSETS (RP. 000)
DECEMBER 31, 1986

PENSION FUND	FIXED ASSETS	CURRENT ASSETS	INVESTMENT FUNDS	OTHERS	TOTAL
YDP. Bank Indonesia	-	20.738.880	81.793.032	-	102.531.912
YDP. & Sokongan BNI'46	8.163.516	74.502.330	216.179.085	65.387.459	364.232.390
YDP. Danar Dana BNI'46	17.783	14.865	498.450	144.067	675.165
Yayasan Jaminan Sosial Karyawan BAPINDO	-	16.793	19.879.593	-	19.896.386
Yayasan Bank Rakyat Indonesia	25.137	4.210.879	131.526.216	-	135.762.232
YDP. Bank Ekspor Impor Indonesia	182	2.262.753	109.440.353	1.916.893	113.620.181
YDP. Bank Tabungan Negara	13.520.246	289.477	36.152.480	-	49.962.103
YDP. & KP. Bank Bumi Daya	5.110.649	16.297.661	29.712.548	-	51.120.858
YDP. Bank Dagang Negara	-	29.442.725	67.387.019	-	96.829.744
YDP. BPD. Jateng	13.230	95.318	738.062	-	846.610
YDP. BPD. Jatim	955	221.192	1.185.283	-	1.407.430
YDP. BPD. Sumut	212.133	1.470	179.144	-	392.747
YDP. Bank Duta	-	131.435	6.308.314	14.045	6.453.794
YDP. MAI Bank Pasar Seri Artha	-	7	166.510	-	166.517
YDP. BPD Sumbar	-	425.600	1.057.384	-	1.482.984
YDP. PT. Bank Nasional	-	61.284	162.660	2.104	226.048
YDP. PT. Asuransi Jasa Indonesia	170.150	2.770.926	12.303.105	-	15.244.181
YDP. PT. Pupuk Sriwijaya	1.014.313	781.962	42.549.098	-	44.345.373
YDP. PT. Tambang Timah	1.257.340	7.376.257	32.744.421	429.317	41.807.335
Yayasan Kesejahteraan Persero Taspen	921	1.865.276	5.114.606	54.312	7.035.115
YDP. PN. Blabak	-	61.633	1.230.299	-	1.291.932
YDP. Pertamina (Yaktapena)	2.377.792	10.072.798	189.142.754	63.040	201.656.384
YDP. Krakatau Steel	52.151	2.866.019	21.207.255	-	24.125.425
YDP. Semen Gresik	4.474	430.053	10.594.944	-	11.035.501
YDP. PT. Asuransi Jayasraya	1.042	55.032	1.069.037	-	1.125.111
YDP. Perum Astek	6.566	12.297	6.356.517	4.074.270	10.449.650
YDP. Intirub	-	5.603	2.005.000	-	2.010.603
YDP. Peruri	2.163.941	493.736	16.520.212	1.553.650	20.731.539
YDP. PT. Semen Padang	62.320	23.305	7.560.142	-	7.654.857
YDP. Elnusa	-	209.902	2.623.948	-	2.808.950
YDP. Waligereja Indonesia	-	160.315	4.816.787	-	4.986.102
YDP. Purbaya	3.060	1.940	242.253	-	247.253
YDP. Pertafiniki	-	52.703	111.945	-	164.738
YDP. Roche Indonesia	-	15.433	122.500	-	137.933
CARRY OVER	34.177.801	175.983.060	1.058.754.936	73.639.157	1.348.554.083

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TABLE 11 (continued)

PENSION FUND	FIXED ASSETS	CURRENT ASSETS	INVESTMENT FUNDS	OTHERS	T O T A L
CARRY OVER	34.177.801	175.983.060	1.058.754.936	73.639.157	1.348.554.083
YDP. Buruh Perindustrian Gula/Karung Goni	26.516	587.037	16.222.086	-	16.835.636
YDP. Dharmayasa Bumiputera	873.261	106.150	4.762.308	-	5.741.719
YDP. Kintaraya	9.166	154.830	6.116.058	-	6.280.054
YDP. Asuransi Panin	-	6.794	385.016	-	391.810
YDP. Pegawai Rumah Sakit Carolus	3.813	9.381	917.096	-	930.290
YDP. Panca Sari Purna	1.119.035	63.066	2.067.081	-	3.249.182
YDP. PETRA	478	3.888	433.336	286.333	724.035
YDP. Yadapen	23.136.351	28.991	962.514	-	24.127.856
YDP. Aseam	-	53	418.490	-	418.543
T O T A L	59.346.420	176.943.259	1.091.038.941	73.925.490	1.401.254.110

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TABLE 12: BREAKDOWN OF INDONESIAN PENSION FUND INVESTMENTS
DECEMBER 31, 1986 (Rp. 000)

PENSION FUND	TIME DEPOSITS	STOCKS	BONDS	REAL ESTATE	PROMISORY NOTES	EQUITY	OTHERS	TOTAL
. Bank Indonesia	74.750.000	758.032	6.285.000	-	-	-	-	81.793.032
. & Sokongan BNI'46	135.929.597	-	-	45.950.329	-	-	34.299.159	216.179.085
. Danar Dana BNI'46	225.000	-	-	264.369	-	-	9.081	498.450
. Yayasan Jaminan Sosial Karyawan BAPINDO	15.580.000	1.028.368	1.971.225	-	1.300.000	-	-	19.879.593
. Bank Rakyat Indonesia	111.795.660	12.678.203	-	7.052.273	-	-	-	131.526.216
. Bank Ekspor Impor Indonesia	59.288.957	19.446.750	-	29.877.267	-	827.379	-	109.440.353
. Bank Tabungan Negara	35.460.300	-	-	692.180	-	-	-	36.152.480
. & KP Bank Bumi Daya	-	23.685.399	-	5.110.649	-	916.500	-	29.712.548
. Bank Dagang Negara	58.574.174	2.051.595	6.7 61.250	-	-	-	-	67.387.019
. BPD Jateng	100.000	625.000	-	13.062	-	-	-	738.062
. BPD Jatim	950.000	-	-	-	-	-	235.283	1.185.283
. BPD Sumut	50.000	-	-	1.850	-	127.294	-	179.144
. Bank Duta	996.100	745.281	-	-	-	-	4.568.933	6.300.314
. MAI Bank Pasar Seri Partha	116.340	-	-	-	-	2.000	48.170	166.510
. BPD Sumbar	1.038.500	-	-	-	-	-	18.884	1.057.384
. PT. Bank Nasional	15.000	-	-	87.138	-	-	60.522	162.[illegible]
. PT. Asuransi Jasa Indonesia	10.685.578	-	880.000	170.150	-	360.000	207.377	12.303.[illegible]
. PT. Pupuk Sriwijaya	37.105.789	276.440	-	1.014.313	-	-	4.152.556	42.549.[illegible]
. PT. Tambang Timah	13.505.633	9.117.323	1.345.000	1.977.015	3.966.983	339.500	2.492.967	32.744.42
[illegible]an Kesejahteraan Persero Taspen	2.949.000	-	-	1.571.208	-	-	594.398	5.114.60
. PN. Blabak	991.150	10.100	-	-	-	-	229.049	1.230.29
. Pertamina (Yaktapena)	118.353.693	-	44.227.721	8.840.875	-	-	17.620.465	180.148.75
. Krakatau Steel	13.249.038	1.008.015	6.000.000	-	-	-	95.202	21.207.25
. Semen Gresik	9.918.500	210.010	-	-	-	67.500	398.934	10.594.94
. PT. Asuransi Jayasraya	618.537	-	-	-	-	450.000	500	1.069.[illegible]
. Perum Astek	3.375.200	320.000	300.000	11.372	-	-	2.349.100	6.356.[illegible]
. Intirub	-	-	-	-	-	-	2.005.000	2.005.[illegible]
. Peruri	12.824.000	-	-	2.163.940	-	-	1.532.272	16.520.2
. PT. Semen Padang	4.345.000	980.000	20.000	1.649.525	-	-	574.617	7.569.1
. Elnusa	1.184.585	-	-	1.141.019	-	251.102	114.242	2.688.9
. Waligereja Indonesia	950.000	-	-	168.787	-	-	3.692.000	4.816.7
CARRY OVER	724.925.331	72.941.441	67.790.196	107.857.321	5.266.983	3.341.275	76.155.711	1.058.278.25

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TABLE 12 (continued)

PENSION FUND	TIME DEPOSITS	STOCKS	BONDS NOTES	REAL ESTATE	PROMISORY	EQUITY	OTHERS	TOTAL
CARRY OVER	724.925.331	72.941.441	67.790.196	107.857.321	5.266.983	3.341.275	76.155.711	1.058.278.258
YDP. Purbaya	126.500	51.190	-	-	-	-	64.563	242.
YDP. Pertafiniki	45.000	17.500	-	-	-	-	49.445	111.
YDP. Roche Indonesia	-	-	-	-	-	-	122.500	122.
YDP. Buruh Perindustrian Gula/Karung Goni	15.835.000	-	300.000	-	-	-	87.086	16.222.
YDP. Dharmayasa Bumiputra	1.770.000	730.000	-	2.262.308	-	-	-	4.762.
YDP. Mintaraga	4.796.000	-	-	1.200.115	-	-	119.943	6.116.
YDP. Asuransi Panin	181.922	86.738	-	-	-	-	116.356	385.
YDP. Pegawai Rumah Sakit Carolus	898.054	13.112	-	-	-	-	5.930	917.
YDP. Panca Sari Purna	982.091	100.000	951.780	-	-	-	33.210	2.067.
YDP. PETRA	375.836	10.000	-	47.500	-	-	-	433.3
YDP. Yadapen	695.000	7.491	-	256.518	-	-	3.505	962.5
YDP. Aseam	400.587	4.683		13.220	-		-	-
-	418.490							
T O T A L	751.031.321	73.962.155	69.055.196	111.623.762	5.266.983	3.341.275	76.758.249	1.091.038.941

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TABLE 13: RECOMMENDATIONS FOR A SUCCESSFUL CAPITAL MARKET

Economic Environment

- The presence of an increasing level of disposable income and investable savings
- Sustainable positive rates of economic growth
- Rational monetary policies that take into account the equity market
- Some development of a middle class
- Economy large enough to support capital market development
- Existence of indigeneous entrepreneurs
- Consumer faith in local currency
- Inflation under control
- Belief that real assets are not the only investment available and that financial assets can be a good investment

Political Environment

- Political stability with a general understanding of the range of possible government actions and policies
- Limited possibilities of nationalization
- Existence of a private sector
- Sense of confidence about the future
- Less than complete reliance on centralized planning system
- Minimal government involvement in non-essential industries

Legal Environment

- Favorable environment and legal framework within which businesses and corporations can operate
- Private and public enterprises considered equal under the law
- Adequate company law for protection of shareholders without seriously affecting a company's ability to finance operations.
- Adequate securities legislation to protect minority shareholders
- Legal system in which disputes are resolved within a short period of time
- Legal system that recognizes rights of lien holders and provides ability to perfect liens in case of legal default

Institutional Environment

- Existence of alternatives to bank finance
- Banks do not have complete control over financial system and companies
- Effective financial institutions for the marketing of equities
- Existence of brokers, dealers and underwriters
- Sufficient trained personnel
- An adequate supply of fairly priced securities
- Beginnings of an institutional system for making data available to the public: price and market information and company information
- An acceptable settlement scheme
- Funded pension funds that are allowed to invest in the market
- Beginnings of an instutional investor market, including the development of mutual funds and insurance companies
- Adequate communications
- Reasonable pricing scheme to buy and sell shares

Regulatory Environment

- Exchange operations as a profitmaking business
- Exchange self regulation as major tool
- Oversight by government agency which also acts as a development institution
- Sufficient trained regulatory personnel
- Effective brokerage system regulation
- Effective disclosure standards
- Acceptable accounting and auditing standards
- Regulatory policies that allow exchange to operate freely

Interest Rate/Exchange Rate Policy

- Best if left open to market forces
- If controlled, then interest rates equal on competing instruments of equal risk
- Some flexibility in interest rates, especially for securities instruments
- Reasonable monetary exchange rate policies
- Central bank involvement in open market operations of money market instruments to set base rate
- A realistic interest rate environment for bank deposits and loans as primary alternative to capital market investments

Taxation Policy

- Taxation of competing instruments equalized
- Equities taxed equally with other instruments
- Elimination of disincentives to market development
- Reasonable corporation taxes (high corporate taxes limit dividend distribution)
- Adequate taxation policies that limit double taxation for domestic and international investors
- Tax inducements to go public to offset decreases in possibilities for tax evasion
- Encourage long-term capital gain with minimal or total elimination of capital gains tax

Institutional Investor Policy

- Guideline for prudent investments by institutional investors
- Diversification
- Limited amounts of "required" government securities investments
- Inclusion of equities as allowable assets for institutional investors
- Funded pension funds with a "fair" amount of freedom to invest in capital market assets

Foreign Investor Policy

- Encourage foreign firms (who are in the domestic market) to list on the market
- Allow listing of domestic firms in other markets (helpful to pricing structure and raising funds)
- Encourage foreign investments through country funds and other means as an alternative source of funds for companies
- Repatriation of profits must be allowed and double taxation eliminated
- Allow foreign ownership through investment in traded securities

The main conclusion which can be drawn from the known data is that the available, but as yet untapped, supply of capital for capital market investments is more than adequate to meet immediate and near-future demand. The supply of securities can only expand at a measured pace and considering the existing base of capital market instruments, there appear to be more than enough funds within the system to satisfy future demand.

Once again, the challenge is to create the environment necessary to shift the use of these funds away from short-term bank deposits into more traditional long-term investment instruments. The tax issue is not a major constraint for pension fund investments because the Ministry of Finance has authorized a tax exemption for interest income earned from these funds' bond investments. It is unclear at this stage if this exemption also covers dividend income from share holdings. As an effort to foster the proper environment for these funds, a significant portion of the technical assistance to be provided in the proposed project must be dedicated towards educating pension fund managers to shift their portfolios into long-term capital market instruments.

2.3 REGULATORY AND TRADING ENVIRONMENT

In Indonesia a great variety of regulations (often conflicting) affect corporate investment as well as the government's role in managing the capital market. In many respects, the underdeveloped nature of the Indonesian capital market can be directly linked to existing regulatory policies, government controls and the legal system. Only recently has there been a concentrated effort to reduce regulatory restrictions on the capital market.

Despite recent deregulation measures, the overall environment is still overly burdened with a general philosophy of "development through regulation." There is a basic belief that the government must be involved if development is to occur. This belief is best demonstrated by the government's propensity to create regulatory institutions before there is a market to regulate. In Indonesia, the government has created a capital market agency as part of the Ministry of Finance which both regulates and manages the exchange operations. This agency, combined with the dominant position of Danareksa, has caused many to believe that the capital market system is just another government program and that "going public" means selling their equity to the government.

Much is made of the fact that in most highly developed financial markets, there are extensive securities laws and regulations. There is a general belief that these laws have actually helped to create and develop these markets when in fact the markets developed on their own with regulations and laws added later to control abuses. Some feel that to avoid the problems which surfaced during the development of other markets, Indonesia must establish strong regulatory controls at the inception. This tendency to rely on regulation should be replaced with a philosophy of market development.

The Indonesian regulatory environment affects capital market development in two distinct ways: direct regulations administered through Bapepam and indirect regulations which may be designed for other institutions but affect such related areas as expansion licenses, interest rates and taxes. It is in this second area where most of the reform and deregulation is needed.

The primary regulatory agency for the Indonesian capital market is Bapepam, a division of the Ministry of Finance established in 1977. Bapepam has been charged to act as both the market regulator and supervisor, and as operator of the stock exchange itself. In effect, it is regulating itself as well as controlling market development through its listing and trading regulations.

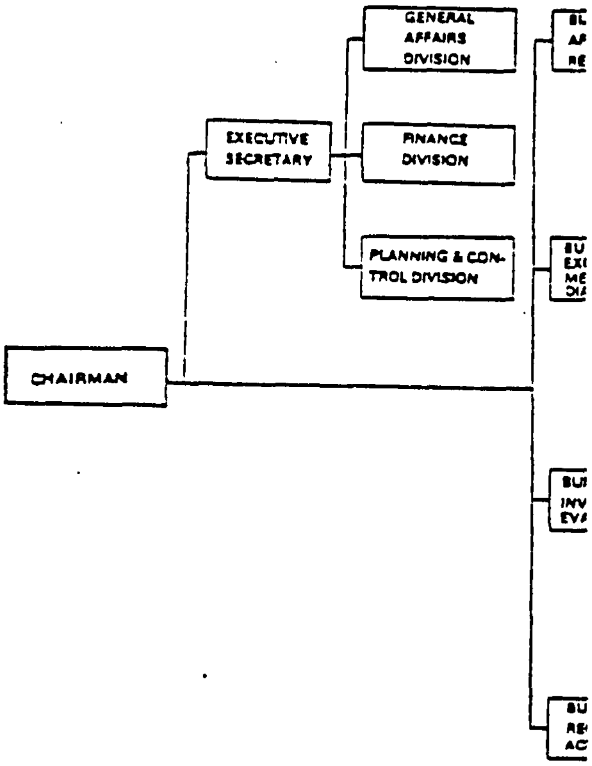
One of the primary impediments to easing the regulatory environment appears to be Bapepam's organizational structure and the continued propensity of its staff to "evaluate" all actions and to provide "market protection." The current organizational structure of Bapepam, as shown in Figure 3, is vertical and inward looking. The main emphasis appears to be on "investigations, evaluations, research and analysis."

Bapepam is organized in such a way as to overemphasize the investigation, evaluation and approval process for listing on the exchange. If for no other reason than the time required to work with such a government agency, these procedures are seen as a disincentive to prospective issuers and underwriters. Bapepam procedures add to the "cost" of raising equity capital. Furthermore, potential issuers are often required to obtain additional licenses and approvals from other government agencies such as BKPM and the Ministry of Finance. Procedures should be revised so that listing on the stock exchange is a "one-step process."

Bapepam's current structure does not properly emphasize its role as stock exchange operator and the implied role that, as market operator, it should also provide a variety of services to exchange members and potential investors. One of the major impediments to further development of the stock exchange and growth in secondary market trading is the almost total lack of current and useful financial information and stock market performance data. Analysis of actual corporate performance for companies listed on the exchange is particularly lacking. Promotional activities, marketing of exchange products, and training of market participants also must be enhanced.

To ease the regulatory burdens and place the proper emphasis on an independent stock exchange operation, it has been recommended that the role of Bapepam be split. It would appear that the regulatory function could best be served if it were integrated within the appropriate division of the Ministry of Finance. This should provide better coordination and implementation of capital market policy and regulation. The operations area of Bapepam would become a separate company responsible for managing the exchange. Initially, this company would

FIGURE 3: BAPEPAM (CA
EXECUTIVE AGENCY) ORGAN



The Indonesian regulatory development in two distinct way: through Bapepam and indirect re institutions but affect such re interest rates and taxes. I is reform and deregulation is need

The primary regulatory age Bapepam, a division of the Mini Bapepam has been charged to act supervisor, and as operator of is regulating itself as well as its listing and trading regulat

One of the primary impedim appears to be Bapepam's organiz propensity of its staff to "eva protection." The current organ in Figure 3, is vertical and in to be on "investigations, evalu

Bapepam is organized in su investigation, evaluation and a exchange. If for no other reas such a government agency, these prospective issuers and underwr "cost" of raising equity capita often required to obtain additi government agencies such as BKP should be revised so that listi process."

Bapepam's current structur stock exchange operator and the should also provide a variety o potential investors. One of th of the stock exchange and growt almost total lack of current an market performance data. Analy companies listed on the exchang activities, marketing of excha participants also must be enhan

To ease the regulatory bu independent stock exchange ope role of Bapepam be split. It w could best be served if it were division of the Ministry of Fin coordination and implementation The operations area of Bapepam responsible for managing the ex still be state-owned but operate as an independent corporation. Over time, the actual operation of the securities exchange could be transfered to the private sector. Such a structure would instill greater investor confidence.

The second area of concern within the overall regulatory environment is the complex system of regulations and government decrees which cover a wide spectrum of the economy and in many ways directly affect capital market development. The main areas of concern are:

+ Investment and licencing regulations,
+ Corporate legal system,
+ Corporate expansion regulations,
+ Legal system for perfecting liens on corporate assets,
+ Bank Indonesia regulations concerning bank reserve requirements and investment practices,
+ Tax structure on financial and capital market instruments, and
+ Standardized accounting and disclosure regulations.

There are, of course, certain aspects of the capital market which do require regulation, such as disclosure of material information by issuers, qualification of securities professionals, and protection of investors. Standards of fairness and honesty must be established to assure that a market can exist as a place where willing buyers and willing sellers with equal access to relevant information meet.

The actual mechanism for trading capital market instruments, or the structure of the marketplace itself, also affect the ability of the market to operate. The trading mechanism of the capital market is largely influenced by the various financial intermediaries, including investment and merchant banks, underwriters, securities brokers and dealers, and market makers. The main problems that need to be addressed can be summarized as follows:

+ Lack of market experience by brokers and dealers. These companies tend to be grossly undercapitalized, lack financial analysis capability and do not actively market their services;

+ Brokers, dealers and underwriters rarely deal for their own account and only take a passive role as facilitator in any securities transaction;

+ Underwriters lack experienced professionals capable of structuring a share or bond offering for a potential issuer and preparing a proper prospectus with full disclosure of relevant financial data;

+ The concept of market maker is not well understood. Underwriters and brokers are averse to taking risk and desire commission income without responsibility;

+ There is no active marketing effort towards prospective investors by these financial intermediaries. Investors report that they are only contacted at the time of a new issue. No ongoing market information or performance analysis is provided by the market brokers and dealers.

As these companies are an important and integral part of any capital market development program, a major training and education effort must be undertaken to strengthen their ability and performance. An additional factor in the trading system is Danareksa, the stale-owned mutual fund. Danareksa operations are covered in Section 5 of this Annex.

2.4 CONCLUSION

The case presented in this section clearly indicates that there is both a strong demand for investment capital and an adequate supply of investable funds in Indonesia. The main problem is the current structural and regulatory environment which acts to prevent these two market forces from meeting. The demand for capital and the supply of capital both suffer from similar constraints. This has caused the market itself to evolve into a vicious circle in which the supply of funds has been forced into short-term bank deposits due to a lack of investment alternatives while the demand for funds is required to seek bank financing due to a lack of alternative sources. The obvious key to break this cycle is to expand the capital market with an increased supply of securities. This can only be accomplished though extensive reforms within the system itself.

The reforms necessary to further promote the development of the Indonesian financial sector, and in particular the capital market, include:

+ Further deregulation of the investment criteria for both foreign investment and corporate expansion.

+ Further reforms within the banking sector to expand its involvement in capital market development, including banks investing in long-term instruments for their own account.

+ A rationalization of the tax laws as regards equal treatment for all financial instruments.

+ Education and training programs for professionals involved in the capital market, including pension fund and insurance company managers, brokers and dealers, and underwriters.

+ Further reform within the central bank in the areas of money market policies, treasury bills, notes and bonds, and bank reserve requirements.

+ Upgrading of professional skills which increases the confidence in financial auditing, accounting and legal systems.

+ Reorganization and further deregulation of the government agencies directly involved in exchange operations and policies. Supervisory responsibilities should be separated from actual market management functions.

Table 13 provides a mcre detailed list of the requirements for a successful capital market.

3. BANK INDONESIA AND MONEY MARKET OPERATIONS

Bank Indonesia's legal entity is based on the Central Bank Act of 1968. While functioning as the country's central bank, Bank Indonesia also extends credits to the economy (namely to banks) which are known as liquidity credits, and direct investment credits to state enterprises. Bank Indonesia also supervises and controls the banking system through its foreign exchange and loan discount windows as well the liquidity of the banks themselves through statutory reserve requirements.

Bank Indonesia dominates the entire financial system, not only through its regulatory controls but also through its direct management of monetary policy and funding of various credit programs. Its total assets amounted to almost 40% of the financial sector's total assets as of year end 1987. This unique combination of central bank and development bank functions places Bank Indonesia in a dominant role for the future development of the Indonesian financial sector.

The role of Bank Indonesia is best measured from the period beginning in June 1983 when a series of banking reforms were introduced. These reforms marked a significant departure from the previous policy under which the banking sector was required to follow strict guidelines. First, Bank Indonesia liberated the interest rates on deposits collected and loans extended by the state commercial banks. Both the state and private banks are now allowed to determine interest rates themselves. Second, it removed the ceiling on state bank credits. This ceiling had been placed annually on the allowable credit expansion during a year and had been the major policy tool for the central bank to control monetary growth. Third, Bank Indonesia announced its intention to withdraw the liquidity credit facility. The facility had been made available to banks at subsidized interest rates as low as 3% per year. Since then, the refinancing facilities have been curtailed, although they still constitute a significant portion of the state banks' funding base.

In January 1984, Bank Indonesia announced additional measures as a sequel to the June 1, 1983 decisions. It introduced a short-term note called a Sertifikat Bank Indonesia (SBI), which it uses to control the money supply. It also instituted a discount window for commercial banks as a monetary control tool. Through these facilities, the central bank functions as a lender of last resort in the financial system. Additionally, since foreign exchange transactions are totally free in Indonesia, Bank Indonesia established a foreign exchange swap facility which is available to the commercial banks (with a foreign exchange licence) and the non-bank financial institutions (NBFIs).

In response to the banking reforms of June 1983, the state commercial banks substantially increased the interest rates paid on their time deposits, which has had a tremendous impact on the mobilization of savings. The level of time deposits at the state commercial banks more than doubled over the six-month period following June 1, 1983. However, these banks did not respond to the removal of the credit ceilings as significantly as they did to the interest rate deregulation. The reason for this may primarily lie in the slow growth of liquidity credits made available to the banks and their unresponsive internal credit approval policies.

As Table 14 illustrates, time deposits within the state banking system grew rapidly after the initial increase in interest rates but have since leveled off. The credits extended by the state banks did not expand as rapidly and only showed an increase corresponding to increases in liquidity credits from Bank Indonesia. The liquidity ratios of these institutions increased as well and only showed a significant decrease in 1987 as loan assets increased 24% to Rp. 18,902 billion. This increase in loan assets is the highest since the June 1983 reforms.

TABLE 14: BANK INDONESIA LIQUIDITY CREDITS AND THE STATE BANK CREDITS
(Rp. billion, at year-end)

	Bank Indonesia Liquidity Credit	Time Deposits at State Banks*	Credits by State Banks	Liquidity (1) Ratio (%)
Amount Outstanding				
1982	3,742	1,231	7,474	13
1983	4,365	2,831	8,854	19
1984	4,670	3,497	10,283	22
1985	6,230	5,337	12,670	15.2
1986	7,126	6,729	15,240	14.3
1987	7,638	6,576	18,902	10.3
Growth Rates (%)				
1983	16.6	129.9	18.5	46
1984	7.0	23.5	16.1	15.8
1985	33.4	52.6	23.2	(30.9)
1986	14.4	26.1	20.3	(5.9)
1987	7.2	(2.3)	24	(27.9)

* Includes rupiah deposits in Bapindo and BTN.
(1) The ratio of liquid assets to current liabilities.
Source: Bank Indonesia Financial Statistics.

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Although the 1983 reforms accelerated the growth of deposits into the banking system, there are still several areas of concern. The desired level of increased competition among the various types of financial institutions has not been achieved, for example, as the state banks continue to account for a disproportionate share of the market. Table 15 schedules the market percentage share for each type of bank.

TABLE 15: THE SHARE OF GROUP BANKS IN TOTAL ASSETS, FUNDS, AND OUTSTANDING LOANS

Group of Banks	% of Assets			% of Loans			% of Funds		
	1985	1986	1987	1985	1986	1987	1985	1986	1987
State banks	73	72	72	74	72	72	67	65	66
Private national banks	15	18	20	18	21	21	19	22	23
Regional development banks	4	3	3	3	3	3	4	4	3
Foreign banks	8	7	6	6	5	4	11	10	8

Further, Bank Indonesia policies continue to favor the state-owned banks through their direct liquidity credits and concurrence in the established preferential access to ("captive") deposits from state-owned enterprises. Despite the announced policy to decrease the state banks' access to them, liquidity credits have increased at an average annual rate of 15.7% since 1983. Bank Indonesia's claim on the all-deposit money banks was Rp. 8,969 billion as of 3/31/87. The state commercial banks owed Bank Indonesia Rp. 6,576 billion, or 73% of this total.

Liquidity credits are in fact a refinancing of the banks' loans to borrowers, when the loans meet the requirements of official development objectives. These include government sponsored programs, such as sugar production and distribution, agricultural production, exports, manufacturing activities, etc. Liquidity credits are also made available for investment purposes (medium- and long-term loans). Direct credits are extended only to official entities and public enterprises to finance the implementation of government programs. Most of the direct credits have been extended to finance food supply and Pertamina's (the state owned oil company) foreign liabilities. The government has reduced the number of programs eligible for these subsidized credits; nevertheless, total liquidity credits accounted for nearly 30% of all loans extended by the state banks as of 3/31/87. There is also concern about the credit review and lending practices which have envolved within these banks as they have depended on these pass-through credits and have not developed the basic banking skills to compete properly. This is reflected in the high level of loan arrears (including Bank Indonesia liquidity credits) in the state bank portfolios.

A basic impact of Bank Indonesia's continued policy favoring state-owned banks is the pressure placed on the other financial institutions, particularly in the area of funding. Private national banks, foreign banks and the NBFIs must rely on deposit gathering or the sale of short-term promissory notes for the majority of their funds. These banks participate to a small degree in official credits eligible for Bank Indonesia liquidity credits but these loans have never exceeded 7-8% of total funding sources (less than Rp. 723 billion as of 3/31/87). In the case of NBFIs, the lack of ready access to a long-term source of funding has compromised their role as investment and merchant banks. The participation of the NBFIs in the development of the capital market has been very weak and generally limited to an occasional bond underwriting. As of 3/31/87, these institutions held less than 3.5% of their assets in securities traded through the stock exchange.

Additional reform will be necessary if the basic structural problems in the financial system are to be resolved. The following list outlines some of the areas which should be addressed:

- Reviewing lending policies to the various economic sectors, and tightening subsidized credits combined with an equalization of access to those funding sources by all banks.
- Reviewing direct lending to state enterprises through the state-owned banks for both appropriateness and interest rates.
- Conducting a complete audit of state-owned commercial banks with the purpose of identifying poor credits, taking appropriate measures to restructure or write-off non-performing loans.
- Undertaking measures to encourage a general decline in bank interest rates (both deposit and lending) to bring them more in line with world market rates.
- Reviewing bank reserve requirements with the purpose of expanding eligible instruments such as SBIs and traded stocks and bonds. This measure would also encourage the development of the capital market.

Bank Indonesia also controls the financial system through its money market policies. These policies include establishing limits on the interbank call money market, stabilizing interest rates in the money market, and influencing transactions and discount rates for direct monetary instruments such as SBI, SBPU and foreign exchange swaps. The Sertifikat Bank Indonesia (SBI) is the only market instrument or treasury debt issued by Bank Indonesia. This instrument is issued largely to control the amount of rupiah in circulation. The sale of SBIs (purchased by banks) draws rupiah out of circulation and their re-purchase (sale by banks) has the opposite effect. Bank Indonesia therefore directly

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influences the money supply by establishing the interest and discount rates for these instruments. This is done by setting a minimum or cut-off rate at the daily auction. As of 3/31/87, outstanding SBIs totalled Rp. 161 billion, of which the banking system held Rp. 117 billion. The state banks and Bapindo were by far the major buyers in this market, holding Rp. 117 billion or 93.3% of the total. The interest rates for these instruments has remained flat at 14% and 15% for 30 day and 90 day maturities, respectively, since August 1985.

The second instrument available in the money market has been the Surat Berharga Pasar or SBPU. This instrument is effectively commercial paper. This paper can be issued directly by banks against their own credit (first name paper) or can be a sale of paper backed by a loan asset held by the bank (two name or third party paper). In order to be marketable, these instruments must be drawn according to specified regulations and be endorsed by the selling bank or NBFI. Currently the maximum maturity for an SBPU is six months and the minimum denomination was recently lowered to Rp. 25 million. It should be noted that banks would tend to sell SBPU paper when they require liquidity or must meet reserve requirements. As illustrated below, these instruments have the opposite effect on the rupiah money supply (cash in circulation) from the point of view of Bank Indonesia.

Instrument	Issuer Seller	Purchaser	Supply
SBI	Bank Indonesia	Banks	Decreases
SBPU	Banks	BI/Ficorinvest	Increases
SBI	Banks (Resell)	Bank Indonesia	Increases
SBPU	BI/Ficorinvest	Banks (repurchase)	Decreases

Ficorinvest, a wholly-owned subsidiary of Bank Indonesia, is the only authorized market maker for SBPUs. It acts as the intervenor in the market for the repurchase of SBIs at a discount before maturity. As of 3/31/87 Ficorinvest held Rp. 966 billion in SBPUs, which represented trading by 69 separate NBFIs. Actual trading volume (total buying and selling) increased by more than four times over the previous year. Ficorinvest has held the spread between buying and selling of SBPUs within a range of 25 to 50 basis points for all maturities.

The sharp increase in banks' SBI holdings since 1985 reflects in part policies to enhance the liquidity of the SBI. On August 1, 1985, banks and NBFIs were allowed to sell their SBIs before maturity to Ficorinvest. Ficorinvest stood ready to discount SBIs, at the interest rate of the original SBI issue without regard to its remaining maturity, and could automatically rediscount them with Bank Indonesia, also at the original issue rate. Under these policies there was virtually no risk of capital loss on SBIs, in effect making them as liquid as excess reserves. This new feature of rediscountability was introduced by Bank Indonesia to lessen the reluctance of banks to purchase SBIs in the absence of an organized secondary market for these instruments, and to strengthen the central bank's ability to inject liquidity into the banking system. However, since August 6, 1986, Ficorinvest began quoting secondary market discount rates for SBIs based on the remaining maturity, and Bank Indonesia has limited its rediscounting to SBIs with a remaining maturity of 21 days or less. No other secondary market exits for this instrument due to the virtual monopoly enjoyed by Ficorinvest.

The holdings of Ficorinvest of the SBPUs for which a particular bank acts as the first endorser are limited to 15% of the third-party liabilities of that bank. However, a bank which has already reached its SBPU limit with Ficorinvest can obtain additional funds from another bank (or NBFI) which is below its SBPU ceiling by issuing a promissory note which can be endorsed by the lending bank and sold to Ficorinvest. Thus banks and NBFIs can utilize each other's limit, and the sum of the specified limits applying to holdings of each bank's SBPUs at Ficorinvest becomes, in effect, the global limit on the total volume of SBPUs that can be created in the system, equivalent to 15% of the liabilities of eligible banks and NBFIs. This has encouraged interbank trading, and thereby the development of the SBPU market.

Ficorinvest, which is still the only marketmaker in SBPUs, is free to set its buying and selling rates within the limits established by the central bank. As of year end 1986, the maximum allowable rate, which is also the rate at which Bank Indonesia buys SBPUs directly from banks and NBFIs, was 17%. Ficorinvest may set rates that are lower than Bank Indonesia's rate by up to four percentage points for all maturities, and by up to three percentage points for maturities of more than one month. The rates at which Ficorinvest can rediscount SBPUs at the central bank were originally set at one half of a percentage point and one percentage point above their buying rate for maturities of up to one month and more than one month, respectively; these intermediation margins, however, have effectively been reduced to 25 to 50 basis points for all maturities since March 6, 1986.

Since the 1985 introduction of new money market instruments, the role of the NBFIs in the money market has grown, a small market for acceptances has emerged, and the significance of the unsecured interbank market has been reduced. Nevertheless, the money market is still in its early phases of development with interest rates effectively set by Bank Indonesia.

The introduction of SBPUs in early 1985 significantly altered the structure of the interbank market. Reflecting their excellent liquidity and exemption from reserve requirements, SBPUs have become the principal vehicle for interbank loans with maturities of one week or longer.

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Partly as a result, the importance of the rupiah interbank market has diminished significantly. The weekly average volume of rupiah interbank transactions had risen steadily in 1983/84, peaking in the third quarter of 1984 at the equivalent of more than 25% of commercial banks' required reserves. In the last quarter of 1984, the volume of interbank transactions fell sharply -- to the equivalent of about 8% of commercial banks' required reserves. Since 1985 the weekly average volume of rupiah interbank transactions has failed to recover, remaining at the equivalent of less than 10% of required reserves throughout 1987, well below 1983 levels.

The decreased utilization of the interbank market is due largely to the structure of the SBPU rates quoted by Ficorinvest. The posted margin between buying and selling rates for SBPUs -- which has ranged between 25 and 50 basis points -- has been lower than the margin that would be needed to offset the cost of reserve requirements on interbank borrowing, thus making borrowing through SBPUs more economical. Also, the money market interest rates increased from 10.53% to over 15% during the past year. As a result, non-SBPU interbank transactions have remained concentrated in the shorter maturities -- one to six days -- for which there is no obvious substitute, while SBPU transactions dominate in the longer maturities. This segmentation of the market by maturity partly explains the observed wide differentials between interbank rates on the one hand, and SBI and SBPU rates on the other.

Under current procedures, market forces seem to play a minor role in the determination of SBI and SBPU rates. Although SBI rates are technically determined by the market in the weekly SBI auctions, in practice Bank Indonesia has pegged the cutoff rate at 14% throughout 1986, leaving the quantity of SBI sales to be demand determined. SBPU rates likewise have moved very little during the last year, with Ficorinvest adjusting its buying rates by more 25 basis points in mid-1986 and leaving them unchanged thereafter. This occurred despite the large movements in the foreign exchange rate. Thus, Bank Indonesia has continuously asserted its own view of money market rates, possibly discouraging the development of trading skills among market participants. In this regard, the continuous posting of a relatively inflexible term structure of interest rates by Ficorinvest has often given rise to unwarranted arbitrage opportunities and has even discouraged money market trading altogether.

To rationalize the structure of money market rates, it is necessary to increase the role of market forces in the determination of interest rates, so that the liquidity of money market instruments is provided primarily by the market rather than by Bank Indonesia's discount window. Bank Indonesia should limit its intervention to the shortest maturities and allow the market to determine the yield curve. More money market instruments with a variety of maturities should be introduced and greater flexibility in how banks can treat instruments must be granted. Such an expanded system would allow the authorities the discretion to intervene as necessary in order to reduce interest rate volatility, while also

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forging closer linkages between money market rates, deposit rates, and loan rates. In particular, to the extent that SBPUs are viewed as a deposit substitute, their yields should be in line with those on deposits of like maturities, adjusted for the cost of reserve requirements. In the longer run, if participation in the SBPU market were to widen to include non-bank and corporate institutional investors, prime borrowers could sell their own promissory notes to investors either directly or through NBFIs, thus stimulating the development of a commercial paper market. Competition from this market could then be expected to keep SBPU rates at levels close to, and possibly slightly below, the prime and commercial paper rates.

Bank Indonesia, in its continuing efforts to improve and stabilize the financial environment, has undertaken considerable internal steps and long-range planning. Plans and actions have involved monetary operations, interest rate policies, reserve management, and technical operations, such as bank clearings and automated check settlement systems. While many of these policy agenda items have been implemented, there are still a number of steps which should be taken to develop the Bank's role in the financial markets.

Among the most important commitments made are those which affect banking service to the public. Since April 1986 banks have been allowed to accept a wider variety of accounts, including joint checking and savings accounts from individuals and institutions. Work is also being done to enhance the clearing activities for bank instruments, both in Jakarta and in the rural areas through branches of Bank Indonesia. However, the clearing and settlement mechanisms are not automated, which causes undue delays and an inability to adjust to increasing volumes. Projects which will improve this clearing system will in turn provide a more conducive environment for the acceptance of checks within the Indonesian banking system. Currently the economy is predominantly cash oriented.

Also important to the development of both the financial and capital markets is bank reserve management, because it impacts the supply of capital in the market. At present, Bank Indonesia may not have an adequate variety of monetary policy instruments for this task. Consideration should therefore be given to the creation of one or more financial instruments of monetary policy capable of controlling the reserve base. Three such instruments might be considered:

<u>Non-Reserve Certificates</u>. Bank Indonesia could offer some form of non-reserve claim like the certificates it issued in 1970-71. These certificates, which would effectively be treasury bills, might be of three or six month maturity and sold at weekly or biweekly auctions to banks and other non-financial buyers. The certificate should be negotiable so that a secondary market could be expected to develop. Bank Indonesia would then be able to intervene in the market to conduct open

market operations. The certificates need not offer any explicit return because they would be sold at a discount. The precise form of the auction would need to be worked out, but the studies prepared in conjuction with the certificate issues of 1970 should be reviewed for initial guidance.

Options on Rediscounts. Monetary control would also be facilitated by ensuring that a reasonable proportion of central bank rediscounts were for nonpriority and hence discretionary (i.e. non-government development projects) loans. Precise control over the total volume of rediscounts could be ensured by auctioning, on a weekly basis, the volume of non-priority rediscounts required to keep central bank domestic credit to banks on track. All banks would be eligible to bid for the fixed supply of these rediscounts.

The relationship between money and income and the overall money supply are subject to prediction errors and data lags. To cushion mistakes, a variable rate rediscount mechanism could be introduced instead of or in tandem with the tender system described above. The essential elements of such a scheme would be:

- o Bank Indonesia announces a basic rediscount rate related to previous interbank market rates or to SIBOR.
- o This basic rate applies to each bank's normal rediscount allowance expressed as some uniform percentage of required reserves (the use of lagged required reserve data would not jeopardize the system).
- o Reserve management, i.e., control over the money supply, would normally aim at keeping banks near their normal allowance ceilings.
- o Borrowing in excess of the normal allowance would take place at penalty rates that rise as excess borrowings increase. The penalty calculation would be set in terms of percentages of required reserves.
- o This rediscount facility might be offered in three tranches. The first tranche would be the normal borrowing allowance provided at an interest rate that reflects adjusted interest parity (e.g., SIBO + expected exchange rate change or SIBOR + inflation differential). The size of this tranche should be based on estimates of the range of random reserve fluctuations. The second tranche would exert moderate pressure. For example, the rate might rise by 1% point above the basic rate for each extra 1 percent of required reserves that a commercial bank borrows from Bank Indonesia. This tranche might be set at, say, 3% of required reserves. The third tranche would exert strong pressure and hence the penalty rate would rise more steeply than it does in the second tranche. The rate might, for example,

rise by 3% points for each extra percent of required reserves that a bank borrows. Again, this tranche might be set at 3% of required reserves.

The graduated penalty rate has two functions. First, it provides limited flexibility to cushion the impact of policy mistakes and unanticipated shocks. Second, it provides immediately available information on credit market conditions. Under competitive conditions, all banks would be paying the same interest rate for additional accommodation through this rediscount facility. For example, suppose Bank A is in the third tranche but Bank B is only in its first tranche. If the interbank rate is above the first tranche discount rate, then Bank B would increase its profits by borrowing more from Bank Indonesia and lending to Bank A. Hence, in equilibrium, the current interbank rate would tend to equal the marginal rediscount rate that all banks were paying to borrow from Bank Indonesia. There would be no special rate or allocation in favor of the state banks.

Reserve Requirements. Varying the required reserve ratio is the main instrument currently available to Bank Indonesia for affecting the link between the reserve base and total money supply. But many monetary specialists are opposed to the use of this instrument on the grounds that it is too blunt, i.e., accommodating a change in the required reserve ratio causes major, sharp adjustments in bank portfolios. This criticism is valid if changes in the reserve ratio involve increases of one or two percentage points that are implemented in one or two steps. But there is no reason, other than convention, for rate changes to be of that nature. It would be equally possible, and much less destabilizing, to carry out gradual changes over a period of several months, e.g., an increase of one-tenth of one percent a week over ten weeks. This would allow banks ample time to adjust their balance sheets, especially if the intended amount and time of the changes was announced in advance. Reductions in reserve requirements generally do not cause banks any serious adjustment problems.

Required reserves, which do not earn any interest, impose a kind of tax on financial intermediation, and the higher the reserve ratio, the higher the tax. The burden may be borne by savers, investors, and/or the depository institutions. Non-interest earning reserves increase the cost of financial intermediation in the domestic banking industry and also encourage savers and investors to do their business abroad. Hence, a strong case can be made for paying a competitive return on required reserves, in both deposit and vault cash form. The interbank rate appears to be the obvious choice. Bank Indonesia could pay this interest on each bank's required reserves for every reporting period upon receipt of the report. No interest whatsoever should be paid on excess reserves. Banks must be encouraged to hold minimal excess reserves in order to stabilize the reserve/deposit ratio.

Last, Bank Indonesia could stimulate and significantly affect the development of the capital market by allowing or even requiring that their money market and reserve instruments be traded through the stock exchange. This would be assisted if the monopoly now enjoyed by Ficorinvest as the only authorized securities trader and market maker for SBIs and SBPUs were dissolved. If SBIs and SBPUs were allowed to seek their own pricing through an open free market system, a more realistic interest rate scenario would develop and an active secondary market for trading would evolve. Those instruments, which are backed by Bank Indonesia, would tend to become the prime paper. Other interest rates, including corporate bonds and eventually bank deposits, would be set at a premium above this government paper. Additionally, Bank Indonesia could broaden the capital market by allowing banks to accept these traded instruments as loan collateral and/or invest in these instruments for their own account.

4. THE COMMODITIES MARKET

4.1 THE POTENTIAL ECONOMIC IMPACT OF A SUCCESSFUL COMMODITY EXCHANGE

A successful commodity exchange can make an important contribution to the economic development of a country. It does so both directly, by providing direct employment, and indirectly, through the additional services, bank deposits, and other economic activities that spring up in support of the exchange.

The employment impact of an exchange reaches far beyond the exchange and its immediate members. Nearly every major industry is linked to an exchange either directly or indirectly by providing products and services to the exchange and its members. It is impossible to measure this total exchange-related employment, but a listing of the organizations involved who are not exchange members provides an idea of the indirect benefits. Such a list would include foreign brokers, commodity pool operators, foreign banks, regulatory bodies, law firms, accounting firms, telecommunication firms, data processing services, data processing equipment vendors, clearing services, security contractors, news services, etc.

The impact of an exchange measured in terms of employment, spending and bank deposits can be substantial. Using Chicago as an example, the following statistics give an indication of the proportional contribution a successful Indonesian Commodities Exchange (ICE) could make to Indonesia.

1. Direct exchange-related employment in the Chicago area for the exchanges and the clearing corporations, their members and selected organizations providing services to the exchanges is estimated to have been just over 33,000 people in 1986.

2. Spending for exchange-related goods and services in the Chicago area by the exchanges and their members was about $870 million in 1986.

3. Visitors and tourists attracted to Chicago specifically because of the exchanges was estimated at $10 million to $15 million for 1986.

4. Average daily exchange-related deposits in Chicago banks in 1986 amounted to $4 billion.

5. Average daily exchange-related borrowings were estimated between $1 billion and $2 billion.

6. Every direct job created by the exchange is believed to create indirectly three jobs in support and other industries. On that basis, it is estimated that the total employment attributable directly or indirectly to the exchanges in Chicago could be nearly 110,000 people.

There are a large number of intangible growth and development benefits that emanate from a successful exchange, including those that come from innovation and the presence of creative people. Innovative activity is like an active yeast. It creates even more innovation and growth.

Although it is difficult to know how the Indonesian Commodity Exchange will develop and how much business it will attract, it can be said with a fair degree of confidence that if it developed into a successful and liquid commodity futures market, it will have an important economic effect on the development of Indonesia.

The success of the ICE futures market depends on its attractiveness to buyers and sellers, whether speculators or hedgers. The attractiveness of a market depends on a number of things, including:

1. The economic importance of the commodities or services listed for trading.

2. The physical facilities.

3. The efficiency of communication facilities domestically and internationally.

4. The state of the banking system and its willingness to support exchange related settlements.

5. The liquidity of the market. Liquidity is the ability to execute large transactions (buy or sell large quantities) quickly without substantial changes in prices of the goods. A market with high liquidity is preferable to one in which the buyer or seller has to wait a long time to complete a transaction, pay a premium, or suffer a discount. Speculators provide liquidity and therefore are necessary to the success of an exchange.

6. The level of transaction costs. Buyers and sellers try to minimize transaction costs as a percentage of the value of a trade. Transaction costs include fees charged by an exchange to execute and clear trades, commissions, and taxes.

7. The fairness and efficiency of the exchange. Customers want to know that their transactions will be processed in a fair and fast manner. They do not want a high rate of failed or unmatched trades, which is a sign that an exchange is not operating efficiently.

8. State of the information systems. Markets that provide complete, accurate and timely information on prices, trading volumes, and other information are much more attractive to buyers and sellers than those markets which lack such information services.

4.1.1 Economic Benefits of Hedging and Pricing

The major reason for the existence of a commodity futures exchange is to provide hedging and pricing services. These are very important benefits to the commercial community.

The Indonesian Futures Exchange would allow producers, processors and exporters of the commodity to hedge their products, thereby reducing their risk. The producers can hedge by selling futures, thus protecting against falling prices. The processors and exporters can hedge by buying futures, thus protecting against rising prices. Overall, this reduction of price risk will make them better credit risks to the banks, thereby strengthening the whole financial and commercial fabric of Indonesia.

If the Exchange is successful in attracting a wide mix of businesses and a high volume of trade, the prices from the Exchange will become recognized the world over as the true barometer of the products' value. This will give the Exchange and Indonesia added visibility and added credibility in the world of commerce.

4.2.1 Summary

In summary, as the ICE grows, it will have a ripple effect on the growth of other industries. Exchange member firms will spend significant amounts of money for commodity exchange-related goods and services in their area. Their major expenditures will be for salaries and wages, interest, rent, data processing, telex communications, advertising and promotion, and general administration. Members of the Exchange will also lease office space, establish bank accounts, borrow funds to finance transactions, purchase office equipment and computers, hire programmers, clerks, accountants and compliance people. These are all very tangible benefits separate from the beneifts that accure to the commodity interests who use the exchange for hedging and pricing.

4.2 REVIEW AND ANALYSIS OF THE EXCHANGE

4.2.1 Exchange Ownership, Organization, and Staff

Current Description. The ICE currently has a staff of approximately 70 people organized into three major operating units — the Secretariat (35 people), the Bureau of Operations (20 people), and the Bureau of Market Development (15 people). These units are further divided into divisions and subdivisions. Exchange organizational rules provide for the following committees: Commodities, Auction (Physicals), Floor Practices, Arbitration, and Membership Qualifications.

At present, there are 50 commodity-specific members of the Exchange and 278 textile members. Membership is a privilege granted by the Exchange Board. Members may be full members or associate members. Members are further subclassified as commodity traders or brokers. Members who wish to become floor members must be approved by the Ministry of Trade. Each of the member classes has various rights and duties.

Areas for Review. The existing staff and organization appear to be adequate to handle the additional duties and responsibilities for trading futures. Certain functions and staff, however, will need to be reassigned at the division and subdivision levels.

The primary issues that need to be resolved include the following: 1) broadening the members' role in owning and managing the exchange should be addressed as a means of facilitating the exchange's growth; 2) the Exchange Committee should have additional responsibilities clearly defined in the rules; 3) additional staff duties and responsibilities will need to be established; and 4) training programs will be required in order to train the existing staff to handle matters relating to futures trading.

Recommendations. The most successful futures exchanges in the world are owned and operated by the members using a consensus method for decision-making. They operate not unlike cooperatives. The members have a direct and strong incentive (self-interest) to build the exchange, enforce its rules, protect their capital, and maintain and enhance their reputation.

- Ownership. As things stand now, it is preferable that the Indonesian Government continue as the owner of the ICE. However, it is recommended that over the next few years steps be taken to allow the members to gradually establish an ownership interest in the exchange. This could be done by setting aside a small fee for every trade made by a member, with such funds accumulating for the purchase of the membership. Ultimately, the exchange would be owned and operated entirely by the member firms and the government would then be strictly in a regulatory role.

  As initial steps, it is recommended that:

  1. The ICE Board of Directors be expanded to include individuals elected by the members; the Chairman of the Board could continue to be appointed by the Minister of Trade.

  2. The Board of the ICE should have responsibility for establishing the rules, regulations and operating procedures on the exchange, and submitting all rules, regulations and modifications thereof to the Advisory Council, or other appropriate authority, for ratification and approval.

- Membership.

  1. The total number of memberships in the exchange should be limited in number (perhaps 100 memberships total).

  2. The memberships should: be of a single class (no major distinctions between full membership, associate membership foreign or domestic members, speculators or hedgers); have

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prepetual life; be transferable (for an openly negotiated price) to a party acceptable to the Board of Directors; confer equal voting rights (one membership, one vote); and confer floor privileges to a single individual per membership.

3. Each membership should: provide access to all commidities listed on the exchange; and be eligible to make application to the clearinghouse through a clearing member for permission to exercise any or all of the following trading rights: 1) to trade as a floor trader for their own account; 2) to trade as a floor broker executing transactions for other members; 3) to trade as a floor trader executing trades for their clearing member only; and 4) to trade as a floor broker executing trades for non-members.

Efforts should be made to encourage individuals to obtain membership in order to become professional floor traders ("locals") and professional floor brokers.

No member should be allowed to exercise trading rights on the floor of the exchange unless that member is guaranteed by a clearing member. See Section 4.3 for an exposition of the clearinghouse guarantee process.

- <u>Committee</u>.

  1. It is recommended that the committee structure of the exchange be expanded to permit more active involvement of the members in the operating of the exchange and the clearinghouse. See also the discussion below regarding committees.

  2. The ICEB should establish a Business Conduct Committee to handle violations of Exchange rules not involving floor practices. (Floor practices matters would continue to be handled by the Floor Practices Committee.)

- <u>Staff</u>

  1. The Exchange will need to establish specific audit and compliance responsibility at the division level. The auditing function would include review of members' financial reports, as well as the conduct of audits or investigations of financial matters. At least initially, the audit unit could cover both the Exchange and the Clearinghouse financial reviews. The compliance staff must have the responsibility for conducting investigations of apparent or alleged violations of Exchange rules. We recommend that the audit and compliance function be combined within the same division which could be under the supervision of either the Secretariat or the Bureau of Operations.

  2. Specific staff responsibility for market surveillance and futures market reporting must also be established.

3. The audit, compliance, and surveillance staff must have a direct line of responsibility through a bureau chief or the Exchange secretary to the appropriate Exchange Committee. For example, the compliance staff must be able to present cases to the Business Conduct Committee either directly or through a designated Exchange official.

4.2.2 Trading Floor Facilities and Procedures

Current Description. The existing floor facilities consist of four trading areas or "rings," and a number of members' booths located around the trading areas. The clearinghouse maintains direct terminal data entry from the trading floor and also has input capability for the Reuters monitor system. Monitor screens around the trading floor display physicals and futures information on Kuala Lumpur and Singapore rubber markets and New York and London coffee markets.

The ICE currently has a telephone order entry system with procedures in place to document and time-stamp trades executed on the Exchange trading floor. The physicals trading is done under a modified "auction" system supervised by an Exchange call chairman and other floor staff. Existing rules provide for an auction committee to resolve immedite problems or disputes arising on the trading floor.

Areas for Review. The existing floor facilities, procedures, and systems represent a good "first stage" in building a futures floor trading capability. In making the transition to a futures exchange, the following floor trading issues will need to be resolved:

- the type of open outcry system to be used;
- the kind of floor price information display system to be designed;
- the trading documents and procedures necessary to handle customer orders and to establish a sufficient "audit trail" record that would enable reconstruction of trading in the case of disputes;
- the development of additional floor trading practices and procedures to ensure orderly and competitive trading in futures; and
- the degree of standardization between the different commodity trading pits or rings.

Recommendations. In order to resolve the above issues, we make the following recommendations:

- With slight modification, the existing floor auction system can be maintained as the procedure for the initial daily opening ("opening call") of each market. Once opened, however, an open outcry system should be expanded to enable traders to bid and offer among themselves within the trading ring subject to established rules, procedures, and proper supervision.

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- o The existing trading "chits" can be maintained as the primary trading and clearing documentation. In addition, a customer order and trading card system should be added, including the time-stamping of orders upon receipt at the members' floor booths, to ensure that an audit trail exists throughout the entire order handling chain.

- o Floor practices, procedures, and rules will need to be develoed to prohibit various abusive futures trading practices and to clearly outline futures business conduct on the trading floor.

- o Current rules authorize each commodity committee to establish trading procedures for their particular commodities. These trading procuedures should all be standardized so that only one set of floor procedures is used for all commodities traded on the Exchange.

- o A "real time" futures price reporting floor display system will need to be develped either by expansion of the current monitor reporting or as a separate floor display system. The price reporting system will need to display various trading information, including the last trade price, current highest bid and lowest offer, the daily high and low prices, maximum daily fluctuation range, volume, settlement prices, and open interest for each futures month open for trading. The system must be able to generate a hard copy permanent record of trading time and sales, trade and settlement prices, and daily volume and open interest.

4.2.3 Exchange Rules

Current Description. Exchange rules, which relate primarily to physicals trading, provide a basic framework for adding the necessary futures trading rules. General areas currently covered include membership, brokers' bank accounts, recording and accounting of transactions, guarantee funds, emergency rules, violations and sanctions, arbitration committee, physicals trading rules, and rubber contract rules.

Areas of Review. The primary issue to be resolved is to identify the additional areas that need to be covered by rules in order to trade futures.

Recommendations. The following recommendations relate to major areas that will need additional rules for the conduct of futures trading. Other rules will need minor revisions or additions to facilitate futures trading.

- o Members Conduct - This chapter will need rules relating to customer margins, risk disclosure, segregation of customer funds, recordkeeping and inspection, handling of customer orders, customers' trading statements, discretionary accounts, and reporting and position limits.

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- o *Floor Practices* - This chapter should cover floor trading procedures, price fluctuation limits, closing price ranges and settlements, handling of floor orders, prohibitions against various trading abuses, and responsibility for trades and errors.

- o *Clearing* - This chapter should identify members' responsibilities to clearing members, requirements for clearing member guarantees, and the necessary rules to ensure coordination and conformity of Exchange and clearinghouse operations and procedures.

- o *Violations and Sanctions* - This existing chapter will need major additions to clearly identify major and minor violations, violations hearing procedures, and sanctions.

4.2.4 Exchange Arbitration Issues

Current Description. Chapter VII of the Exchange rule book currently provides rules for arbitration of disputes "arising out of the execution of any contracts." The rules provide a detailed procedure for selection of the arbitration panel, the setting of arbitration hearing dates, and provide that the default on payment of an award by a member shall constitute a "serious offense." Arbitration proceedings may be held "within the building of the Indonesian Commodity Exchange Board or at another place."

Areas for Review. Exchange rules appear to provide a good general framework for arbitration of disputes over physicals transactions. In fact, the Exchange arbitration offers an advantage over physical contracts made off the Exchange. The ICEB may wish to emphasize this advantage when encouraging traders to execute physicals transactions on the Exchange. In doing this, of course, the "track record" in handling the arbitrations becomes very important. Therefore, the Exchange must ensure that its arbitration proceedings are fair, prompt, and can be entered into without considerable expense.

The Exchange rules also form a base for adding arbitration of futures contract disputes. In making the transition, the following issues will need to be resolved:

- o What type of claims may be arbitrated?

- o What are the requirements for entering into arbitration? (For example, do both parties have to agree or is the member obligated to arbitrate a claim if requested to do so by a customer?)

- o Should there be a monetary limitation on the size of claim that may be arbitrated?

- o What forums are available to resolve claims that cannot be arbitrated?

- o Who will enforce the arbitration award?

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Recommendations. The actual changes in the arbitration rules will need to be made by the Exchange's attorneys in order to ensure that they comply with applicable legal requirements. At this time, we recommend the following:

- The scope of arbitration for futures contract disputes should be expanded from "execution of a transaction" to include any violation of Exchange rules. The Business Conduct Committee or the Chief Executive should decide whether a particular claim can be arbitrated or whether the matter should be handled by the Business Conduct Committee, Board, or is otherwise not eligible for arbitration.

- If a claim is eligible for arbitration, then a member should be obligated by Exchange rules to arbitrate a claim if requested by a customer.

- The arbitration provision should be explained in the trading agreement signed by a customer of a member firm.

- An arbitration decision should be appealable, on limited grounds, to the Board which should have the power to direct a member to pay the award. Failure of a member to pay a claim should subject the member to Exchange disciplinary action.

- A time limitation, such as one year, should be placed on the filing of an arbitration claim.

- To provide for the extraordinary instance in which a member firm's assets are insufficient to enforce an arbitration award for fraud or dishonest dealings only, the complaintant would have last recorse only to the bankruptcy courts or, alternatively, the Exchange may want to handle such a situation by establishing a special insurance fund, with monies to be obtained from a small charge per transaction.

- Arbitration procedures should not replace the Exchange's own duty to conduct investigations and to take disciplinary action against members for violation of Exchange rules.

4.2.5 Commodity Contract Specification

A crucial element in the development of a successful futures exchange is the establishment of fair and equitable contract terms and conditions that are representative of and acceptable to commercial interests, both domestic and international. The establishment of such terms and conditions is not always easy because they must reflect the needs of a broad spectrum of interests, i.e., producers, exporters, dealers, processors, traders and investors. For futures trading to succeed, such a contract must have predetermined specifications as to: quantity of product, locations of product, quality of product, terms and conditions of payment, and time of delivery.

It is not within the scope of this report to recommend the commodities (rubber, coffee, etc.). Such terms and conditions must be arrived at through consensus of the members of the exchange and the various interests who produce, market and deal in the physical product domestically and internationally.

It is recommended that ICE establish a committee composed of members of the ICE, producers, Department of Agriculture representatives, dealers, processors and exporters to establish the contract terms and conditions for each commodity traded on the exchange. Once such terms and conditions are agreed upon, they should be recommended to the Board of Directors who can accept, reject, or modify them before submission to the Advisory Council, or other appropriate authority, for approval as the official rules of the exchange.

Discussions we held in Jakarta, however, indicated that consensus on the futures contract terms and conditions for coffee, and maybe rubber, should be easily established. Many of the terms and conditions contained in the current physicals' contracts will be useful in guiding the committees to the appropriate terms and conditions of a futures contract.

4.3 CLEARINGHOUSE

4.3.1 Staff and Organization

Current Description. The clearinghouse operates as a separate business entity owned and guaranteed by the government. It is under the jurisdiction of the Ministry of Finance. The clearinghouse has a staff of approximately 20 people organized into four operating units -- Deliveries (2 people), Operations (11 people), Cash (2 people), and Bookkeeping (5 people). The clearinghouse clears physicals transactions in rubber and coffee and processes the transfers to textile quotas. The organization's rules currently are limited to physicals trading. It collects a small fee for each transaction cleared, and for this fee, guarantees the transactions to both parties.

Areas for Review. While it is healthy to have a certain amount of autonomy in the management of the Exchange and the clearinghouse, the degree of independence needs to be limited. Any conflicts of interest that might arise in the resolution of problems arising from trading activity can be handled through properly crafted rules and procedures.

The ownership of the clearinghouse and the government's role as the ultimate guarantor of the exchange should be reviewed to assure the greatest incentives for members to help the exchange grow and succeed while limiting, but not eliminating, their risk.

Recommendations. It is recommended that:

o The Board of Directors of the clearinghouse be composed of a majority appointed from the ICE Board of Directors, plus two members appointed by the Chairman from the commercial banking community.

- The government should consider selling a minority interest in the clearinghouse to private commercial banks who are directly involved in financing commodity transactions.

- The governnment should, for the time being, continue to provide the final guarantee of the clearinghouse in the instance that a default or other problem results in the clearinghouse suffering a shortfall of funds sufficient to satisfy all creditors. To help establish a contingency fund for such guarantee and to allow the exchange members to gradually purchase a majority ownership in the clearinghouse over the coming years, the government should consider setting aside a small amount of each clearing fee in a special "member equity" fund. All rules and regulations of the clearinghouse should be subject to approval by the Advisory Council, or other appropriate authority.

4.3.2 <u>Operation of the Clearinghouse</u>

<u>Areas for Review</u>. In making the transition to a futures clearinghouse, the following issues need to be resolved:

- Changes will be necessary in the computer hardware and in the software programs. (The computer is currently at near full capacity with approximately 40% of its operating time utilized in processing textile quota transfers. In addition, futures clearing will require new programs to handle functions such as calculation of margins, daily pays and collects, cash and non-cash inventories, and the assignment of deliveries.)

- The type of margin system and the acceptable form of margin payment will need to be determined.

- Clearing member qualifications and financial requirements will have to be developed.

- Various clearing records, such as trade registers, margin recaps, and delivery runs must be designed.

- A clearinghouse/clearing member banking system will have to be established.

- Clearing member customer trade accounting systems, and the degree of clearinghouse input in generating those records, will need to be determined.

- A system for close coordination between Exchange and Clearinghouse actions and operations must be implemented prior to clearing futures contracts.

- The type of guaratee system will need to be resolved (see Section 4.3.3 which follows).

Recommendations. The following recommendations are limited to policy issues. Specific recommendations regarding computer programs, record system, acceptable forms of margin payment, and banking procedures should be made at a later date after general policy issues have been decided.

- The clearinghouse should use a gross margining system whereby each purchase and sale would be margined at the clearinghouse level.
- Variation margins should be paid and collected on a daily basis.
- Clearing members should be required to guarantee an Exchange member before that member may trade on the floor of the Exchange.
- The rules of the clearinghouse and the Exchange should ensure close coordination between the two entities and provide that emergency actions ordered by the exchange are implemented by the clearinghouse.
- An extensive training program should be designed and implemented. (With sufficient training and systems redesign, the current staff level of the clearinghouse should be adequate to handle the additional workload of clearing futures transactions.)

4.3.3 Clearinghouse Guarantee Funds

Current Description. Rules relating to guarantee funds are currently contained in Chapter IV of the Exchange Rules. These rules provide in part, that:

- The clearinghouse shall receive and maintain the guarantee funds; and
- The funds shall be used to fulfill indemnity arbitration claims within a dispute resolution framework of the exchange in the event that the losing party cannot pay the claim.

Areas for Review. A degree of confusion exists over the purpose of the guarantee funds and whether they should be used for payment of arbitration awards for violation of exchange rules. To clarify this matter, the following issues need to be resolved:

- What is the proper use of a clearinghouse guarantee fund?
- Who controls the funds and interprets the rules and procedures regarding deposits, maintenance, and use of the guarantee funds?
- What constitutes a clearing member default to the clearinghouse and what is the priority of payment from the defaulting clearing member, excess clearinghouse funds, guarantee funds, and any necessary follow-up assessments and liability limitation?
- What should be the size and composition of the fund, who should contribute, and how should the guarantee be refunded, if necessary?

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- o What should be covered by Exchange arbitration and what is the exchange's role in directing payment of arbitration awards? (See Section 4.2.4, Exchange Arbitration.)

Recommendations

- o A guarantee fund should be established, maintained, and operated by the clearinghouse; clearinghouse rules should provide for the deposit, use, and distribution of funds; and the clearinghouse board should be responsible for interpretation of rules and the taking of prompt action in the event of a default by a clearing member.

- o The guarantee fund should consist of deposits from clearing members; the amount of the deposit should depend on the amount of business handled; and the rules should provide for the return of the deposit if a member in good standing gives up its clearing membership.

- o The use of the guarantee funds should be limited to a margin, deposit, fee, assessment, or other default of a clearing member's obligation to the clearinghouse. The board, not an arbitration committee, should determine when a default, as defined in clearinghouse rules, has occurred.

- o Clearinghouse rules relating to guarantee funds should include the following:

  1. a definition of default;

  2. procedures for the prompt transfer of open positions from the defaulting clearing member to other clearing members;

  3. provisions for pursuing clearinghouse claims agains the assets, including exchange memberships, of the defaulting clearing member; and

  4. procedures for follow-up assessments and determination of the extent of liability of clearing members.

- o Claims arising form arbitration awards for members and customers alleging violation of exchange rules should not be guaranteed by the clearinghouse guarantee funds. The exchange arbitration panel or Business Conduct Committee should direct the exchange member losing the arbitration to make payment and take action against any member who fails to comply. (See Section 4.2.4, Exchange Arbitration.)

4.3.4 Clearinghouse Rules

Current Description. Existing clearinghouse rules provide for general provision, including contract substitution, clearinghouse liability to contracts with clearing members, and clearing member accounts. In addition, the rules provide for physicals trading settlement provisions for rubber and coffee. The rules also contain a provision that "any dispute arising under or in relation to these regulations between a member and the Persero Kliring shall be subject to the Secretariate of the Central Jakarta District Court."

Areas for Review. The clearinghouse will need to expand its rules in order to accommodate futures trading. In developing the additional rules, the following major issues will need to be resolved:

- The rules must provide for close coordination between clearinghouse and exchange operations, and emergency actions.
- Clearing membership provision must be determined, including financial requirements, number of exchange memberships required, the provisions for clearing member guarantee of non-clearing exchange members, and the transfer of memberships.
- Rules and procedures must be developed for futures clearing, including trade matching and processing, futures clearing reports, position offsets, and position transfers.
- Rules and procedures for setting margin rates, collecting deposits, and accounting for margin funds will need to be developed.
- Delivery provision and procedures must be written, including issuance and assignment of delivery notices, payment for the receipt of delivery, clearing member duties, and delivery default.
- The clearinghouse and the exchange will need to work together to develop procedures for determining daily settlement prices.

Recommendations. A number of specific recommendations will necessarily need to be made during the actual writing of the rules. At this time, we make the following general recommendations:

- Since the exchange and clearinghouse are operated as separate entities, rules should provide for coordination of actions, including:

    1. ICEB approval for changes in clearinghouse rules that affect clearing and settlements.
    2. A provision that the clearinghouse must implement emergency actions taken by the ICEB.
    3. A provision requiring coordination, including the exchange of reporting and financial information, between the chief operating officers of the clearinghouse and the exchange.

- Minimum financial requirements and minimum required working capital should be periodically reviewed and increased for clearing members handling an increased volume of business.

- The clearinghouse should consider establishing a clearinghouse committee that would meet more often than the board and would have responsibility for review of margins, position surveillance, and other matters as determined by the rules or by the clearinghouse board.

- The rules should clearly define the duties and responsibilities of the board, the clearinghouse committee, and the chief executive officer.

- An internal procedure for resolving disputes with clearing members prior to resorting to court action should be developed. In addition, rules should provide for disciplinary actions by the clearinghouse against clearing members who violate the rules or procedures.

5. DANAREKSA OPERATIONS

P.T. Danareksa was established as the national investment and unit trust fund in December 1976 under the authority of Government Regulation No. 25-1976. The authorized functions and objectives of Danareksa are to:

- act as an issuer of mutual fund certificates which are secured by shares and bonds purchased in the capital market,
- encourage public participation in corporate share ownership and distribute the benefits of share ownership to the public through the sale of affordable share certificates, and
- act as a broker, dealer and underwriter of securities in the capital market. Danareksa is also authorized, through subsequent decrees, to "act as a financial institution" by trading and investing for its own account in the local money market.

The Government of Indonesia (GOI) owns all 35,000 of Danareksa's issued shares. Danareksa's authorized capital is Rp. 50 billion, of which Rp. 35.2 billion is paid in.

When the stock exchange was re-established in 1977, it become apparent that the GOI would need to intervene in this new market, both to act as a stabilizing agent and to support its growth while ensuring the equitable distribution of shares throughout the populace. This "mixed-economy" approach appeared valid at the time due to the embryonic nature of the market and the goal of implementing a program of "Indonesianization" for foreign-controlled joint ventures. As the market has evolved however, P.T. Danareksa has grown into a multi-billion rupiah company which has assumed a much more complex and dominant role than originally conceived.

While the original concept behind the establishment of Danareksa remains valid and there continues to be a need for a broadly based investment trust, it is also apparent that the current structure and operations of Danareksa must be changed in order to promote a well developed and free-trading capital market. It can be argued that Danareksa has actually become a deterrent to capital market development in direct contradiction to its original mandate. Because of its dominance of a very small market (it owns over 50% of all shares listed on the exchange) and the structure of its fund certificates, this unit trust is actually a primary cause for the almost total lack of a secondary market in Indonesia.

It is obvious that without a significant re-structuring of both the method of operation and the preferential role of Danareksa, there will be no further development of the Indonesian capital market. Danareksa totally dominates the supply side of share issues by being a vociferous underwriter and purchaser of share and bond issues. It also impedes the demand side the market through the no-risk-structure of its certificates, which offer both a guaranteed minimum rate of return and a guaranteed repurchase at face value. Hence there is little incentive to trade these certificates or to buy shares directly. There will be little growth or development of the newly approved parallel market (Bursa Paralel) if Danareksa is permitted to dominate this exchange as well.

It is recognized that the current situation is not a recent event but has in fact evolved over the past ten years. Unfortunately, during this period, a set of philosophies and "truisms" developed to the point where many of the company's actions are now the result of self-fulfilling prophices. For example, the strong desire to report ever increasing profitablility has led to the use of a number of misleading and improper accounting practices. Correcting these errors now will cause Danareksa to report a one-time writedown of assets against retained earnings in excess of Rp. 18 million, or 35% of reported capital reserves.

Danareksa also maintains that it has been "forced" to buy large blocks of various share issues in the market because "there are no other buyers." This seems to be a case of being caught up in a vicious circle because of the cause and effect relationship of Danareksa's dominance of the market and the fixed return nature of their certificates. They own such a large proportion of the total shares issued that they have effectively stifled the market's desire to compete with them, thereby leaving Danareksa the only "buyer" willing to make a market. They have been able to sell some bond certificates held through the secondary market only due to these fixed rates of return. However, there is little incentive for an investor to purchase shares in the secondary market which have a significant price fluctuation (loss) risk when Danareksa itself will assume this risk and issue certificates which are effectively government guaranteed bonds.

The result of these policies has been to help depress the very market Danareksa was created to stimulate. Since 1977 only 24 companies have listed shares on the stock exchange; 18 of these are joint-venture companies that were strongly encouraged to adopt this approach in compliance with government limitations on foreign investment and to take advantage of tax incentives offered. There has been no new stock issue on the Jakarta exchange since 1984. There have been 16 separate bond issues floated in the period since 1983, but all of these were from only three different government agencies. Again, it appears that Danareksa and its pricing mechanisms have served as a deterent in this market as no private firms have attempted a bond issue to date.

Recently, the government issued a comprehensive series of decrees to 1) further de-regulate the mechanics of the stock exchange and 2) create a new parallel market designed to attract new companies to list their shares. These decrees were welcomed as a very positive step towards re-vitalizing the capital market as they eliminated a number of procedural disincentives that had affected the supply side of the market. Among the most positive changes are the allowance for foreign ownership of stock and the elimination of Danareksa's preferential right to purchase up to 50% of any new share issue. The main impediment remaining is the continued high cost of equity capital versus debt financing for possible new entrants and the attractiveness of alternative investments in bank time deposits for possible investors.

A brief review of the operations of P.T. Danareksa revealed a number of administrative, structural and accounting problems which seriously affect the company's performance and ability to fulfill its mandated role and negatively affect the development of the capital market in general. These problems can be categorized into three areas:

- o the dominant position of Danareksa in the capital market;
- o the inability to implement an effective share distribution system to the public through Danareksa certificates; and
- o the failure to follow consistent and acceptable accounting practices and the need to provide timely dissemination of financial data to investors.

5.1 DANAREKSA MARKET POSITION

As previously mentioned, Danareksa has grown to such a size over the past 10 years that it now totally dominates the stock exchange. As of 12/31/87, Danareksa owned a total 29,853,292 shares or 50.97% of the total shares listed in the market. A breakdown of this share ownership reveals some interesting facts:

Total shares listed on exchange:	58,569,311	
Total shares owned by Danareksa:	29,853,292	
of which:	3,809,800	are pledged for "back-to-back" certificates
	11,221,105	are pledges for Danareksa certificates
	14,822,387	are held in portfolio unencumbered*

A total of 50.3% of the shares owned are actually used as security for Danareksa certificates issued. Since the back-to-back certificates are the only true single-issue mutual funds, the actual percentage of shares pledged on the Dana Umum certificates is only 43% of the total

* Unencumbered means that the shares are without any lien and are not pledged as security for any fund certificates issued.

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shares owned and available for this purpose. This statistic shows that Danareksa has gone far beyond the level of share purchasing necessary to complete its mandate of capital and income distribution. They should either issue more certificates utilizing their existing portfolio as security or sell these unencumbered shares outright to other investors. It is disturbing to note that despite the issuance of Dana Umum certificate series E in 1987, the number of shares held in the portfolio unencumbered actually increased by 193,192. This means that Danareksa was once again a net purchaser of shares in the market during 1987.

It will be a long and somewhat difficult process to effectively unwind Danareksa from its present position of dominance because of the absolute size of its portfolio as well as the very shallow nature of the market. In effect, Danareksa is its own worst enemy in the situation because almost any action it takes will have a significant impact on the market and share prices. Danareksa cannot just "dump" its shares, as the market is too thin. Also, it must realize that most of the shares held will have to be "marked to market" before any buyers will show interest. This action has been an anathema to Danareksa management who continue to value portfolio investments at the original purchase price. They simply refuse to accept a loss. Nevertheless, Danareksa should begin the process of disengaging itself from the dominant role it has assumed and scale back its operations to a more realistic and dynamic level.

In the process of relinquishing its control of the market, Danareksa must also re-structure the terms and conditions of the certificates that it issues. By the very nature of issuing a medium-term certificate which guarantees a minimum cash dividend, based upon one-year bank deposit rates, and whose future repurchase is also guaranteed by the issuer, Danareksa is simultaneously competing with the bond market, the financial money market and the secondary share market. In fact, these certificates are a major impediment to the development of a secondary market for several reasons:

- o They guarantee a cash dividend which is unrelated to actual stock values. Therefore, they do not carry the same level of risk as owning a share directly.

- o They are virtually "risk free" as the issuer, a government agency, guarantees repurchase at face value less a slight commission.

- o The issuer, Danareksa, owns over 50% of all shares listed and even though most shares held are not securing these certificates, the issuer does not trade actively. Danareksa has historically been a net buyer for its own account. Other investors are reluctant to even attempt to compete with Danareksa.

- o Danareksa receives long-term governments funds at subsidized interest rates which allows it to hold shares in its portfolio for long periods. Long-term funds are not readily available to other potential traders or possible fund managers such as the NBFIs.

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- The formula for dividend payment (based on one-year bank deposit rates) perpetuates and reinforces the market psychology towards immediate cash dividend income versus share appreciation and capital gains.

The actual effect of the structural terms and conditions of the certificates issued by Danareksa, with a guaranteed return fixed to 1 year bank deposit yields, is to impede the development of a secondary market by removing all possible share appreciation and risk/reward mechanisms from the investors. Investors in Dana Umum certificates effectively hold a term, bond-like instrument and need not concern themselves with actual movements in share prices or corporate performance.

Danareksa does not issue new share unit dividends (increased ownership in certificates) in the mutual fund if share prices increase. In fact, Danareksa has a vested interest in supporting stock prices in order to protect itself against its own open position due to the fixed minimum rate of its certificate liability. If stocks appreciate in value, Danareksa closes its funding gap liability. However, it does not pass on increased value to investors and has only rarely decreased its dividend payout rate. This is not a free market investment trust or a competitive mutual fund.

A final important reason why Danareksa should re-structure its certificates is the huge open position the company carries between the nature of its revenue sources and its dividend liability. Historically Danareksa has paid a dividend rate of 18% p.a. on its Dana Umum certificates, only occasionally adjusting this return downward to reflect a decrease in bank interest rates. However, during this same period, dividend income from shares held has decreased in absolute (per share) terms. Consequently a greater portion of the dividends paid out to certificate holders annually is actually being subsidized by dividend earnings from unencumbered shares and interest income on bonds and bank deposits. In fact almost 23% of Danareka's total income comes from interest earnings in the money market (bank time deposits and short-term notes). If these interest rates decrease, the company faces a significant liquidity crisis. By comparison, only 24.6% of total income comes from dividends received for shares owned.

The pitfalls in this investment position are even more apparent when one analyzes the composition of each Dana Umum fund. Table 16 illustrates the income source for each fund. P.T. Danareksa income from each of these sources (held unencumbered in its portfolio) is also shown.

As can be seen, only an average of 37.9% of the total income for the four Dana Umum series comes from dividend income for the shares held. The total income level is being supported strongly by bond and bank deposit interest income - 58.4% of total income. The bond yields are fixed for the five-year life of the instrument. However, the interest rates on bank deposits are subject to significant movement and are currently decreasing to a level of 15-17% for one-year deposits. As a result of the dependence on fixed bond income (the average for all issues is 16.27%), these funds are unlikely to increase their actual income levels in the near future. Certainly they will not increase significantly until there is a greater development in the share market, an active secondary market and increased dividend income due to corporate performance.

Additionally, Table 16 reveals the negative spread for the funds with an average R.O.A. of 16% when they have traditionally paid 18%. In order to continue paying such a dividend yield on the Dana Umum certificates, Danareksa must utilize a considerable portion of its earnings from other assets. At an 18% dividend rate, Danareksa must pay out a total of Rp. 10.8 billion, which is approximately a Rp. 1 billion shortfall from the total earnings of the funds. This amount equals almost 30% of Danareksa earnings from unencumbered bank deposits in 1986. This source of income, which is highly volatile, represents 43.9% of Danareksa's actual income for that year. As interest rates fluctuate, so will Danareksa's net earnings as long as they maintain a basically fixed dividend payout policy.

The above analysis utilized 1986 financial data. It would appear from preliminary data for 1987 that the negative impact of this certificate structure is even more pronounced because bank interest rates declined over the year and dividend income did not improve significantly. It is strongly recommended, therefore, that an in-depth financial analysis of the company's cash flow position, complete with projections for various interest rate scenarios, be initiated as soon as possible. The current policy of certificate structure is a financial time bomb.

5.2 DANAREKSA/SECONDARY MARKET DEVELOPMENT

As described above, Danareksa and its method of operation are one of the main reasons for the almost complete lack of a secondary trade market for shares in Indonesia. The other impediment is an unequal tax policy which is discriminatory towards the capital market and is a subject for separate study. Danareksa can help stimulate the growth of the secondary market by implementing several new policies:

o Danareksa should not continue to act as an underwriter in the primary market and relinquish this role to the NBFIs and commercial banks.

o Danareksa should desist from intervening in the market for its own purposes or because of a perceived need to stabilize share prices. A free market environment must be established before investors will be able to realize capital gains. In a less manipulated market, the NBFIs and other institutional investors can become more active in funding and investing for their own account as well as their clients'.

TABLE 16: DANA UMUM FUND

1986

DANA UMUM SERIES	INCOME FROM DIVIDENDS	% of Total for Series	INCOME FROM BANK DEPOSITS	% of Total for Series	INCOME FROM BOND INTEREST	% of total	INCOME FROM PROMISSORY NOTES	% of Total for Series	TOTAL INCOME FOR SERIES (OR PT DANA REKSA PORT-FOLIO)	TOTAL EARNING ASSETS FOR SERIES (SHARES, DEPOSITS, BONDS AND NOTES) OR DANAREKSA PORTFOLIO	R.O.A. FOR EACH SERIES
A	1,310,175,744	52.4	218,542,114	8.73	884,741,167	35.4	89,114,002	3.56	2,502,573,027	14,913,107,000	16.8%
B	480,362,708	18.9	782,308,306	30.7	1,177,866,618	46.3	105,751,329	4.1	2,546,288,961	15,347,305,000	16.6%
C	836,841,000	37.8	395,542,182	17.8	924,394,500	41.7	59,850,795	2.7	2,216,628,477	15,480,338,000	14.3%
D	1,056,130,689	43.2	492,468,794	20.1	794,677,111	32.5	102,429,512	4.2	2,445,706,106	14,952,721,000	16.4%
TOTAL	3,683,510,136	37.9	1,888,861,395	19.5	3,781,679,396	38.9	357,145,638	3.7	9,711,196,571	60,693,471,000	16.0%
PT DANAREKSA (own port-folio)	3,268,387,576	42	3,392,122,720	43.7	1,085,973,690	13.9	27,747,142	.4	7,774,331,098	60,088,540,000	12.9%
GRAND TOTAL									17,485,527,669		

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- Danareksa should begin to gradually sell its excess holdings back to the market and diminish its overwhelming position as a 51% owner of all shares listed. The company should concentrate its efforts on its original role as a unit trust fund.

- Danareksa should allow and encourage competition in the mutual fund market. The best opportunity to do this is to work closely with NBFIs and assist them in obtaining the long-term funding they require if they are to hold shares in their portfolio. The following swap transaction is an example of the type of action that could be taken. This transaction would be beneficial to both parties and capital market development in general:

  1. A swap or trade of assets is negotiated between Danareksa and a syndicate group of NBFIs (possibly including commercial banks).

  2. Danareksa swaps a portion of its excess (unencumbered) investment assets (stocks, bonds, time deposits) for promissory notes issued by the syndicate group.

  3. NBFI promissory notes are of medium-term maturity (3-5 years) and could carry a variable rate of interest as negotiated.

  4. Danareksa now holds NBFIs notes and NBFIs hold shares in listed companies. Both parties would now be able to issue a new mutual fund backed or secured by these assets.

  5. The new Danareksa certificate could be a true mutual income fund based upon rates of NBFI notes.

  6. NBFI mutual fund certificates would also have income potential based upon actual share performance. NBFIs would not incur the same mismatch in revenue and liability as Danareksa currently experiences.

  7. Income from sale of NBFI mutual funds would be available for additional corporate lending and a greater percentage could be extended for longer terms than currently offered.

  8. Danareksa would effectively dilute its dominant position as share owner and issue a new certificate backed by the creditworthiness of the syndicate of NBFIs.

  9. The net result of such a transaction would be a shift in share ownership towards the private sector and an increase in the marketable securities available to the investor market. A secondary market in both new fund certificates should develop.

A considerable amount of negotiation must take place before such a transaction would be workable. Nonetheless, it is recommended that Danareksa begin this process and work towards implementing this or alternative financial transactions. Such innovative action will be necessary in order to stimulate and develop an active secondary market in Indonesia.

5.3 DANAREKSA CERTIFICATE DISTRIBUTION

One of the primary rationale for establishing P.T. Danareksa was to create a vehicle which would encourage public ownership in the corporate assets traded on the stock exchange and to pass on the benefits, or income, of such ownership to a wide section of the population. This distribution was to be accomplished through the purchase of shares by Danareksa and the simultaneous issue of affordable fund certificates to the people. A single certificate priced at Rp. 10,000 was considered a proper level of affordability. Whether by management policy or as a result of external circumstances, Danareksa has failed carry out this function.

Through December 1986, Danareksa had issued a total of 15,420,300 certificates consisting of the following types:

Certificate Type	Total Issued	Total Sold	Total Held in Portfolio	Total Value 12/31/86 (Moving Average Price)
A. Back-to-back Certificates	1,420,300	724,043	696,257	Rp. 10,836,469,000
B. Dana Umum Certificates Series A-D	6,000,000	5,750,953	249,047	Rp. 62,091,071,000
C. Dana Bond Income Unit Certificates I-III	8,000,000	7,610,826	389,174	Rp. 80,000,000,000
Total	15,420,300	14,085,822	1,334,478	Rp.152,927,540,000

Currently only 8.7% of the total certificates issued remain in the Danareksa portfolio as unsold. These certificates have a nominal value of Rp. 13.3 billion and an average value as of 12/31/87 of Rp. 12.1 billion. The remaining 92.3% of the certificates issued have been sold. The problem is to whom they have been sold and how Danareksa reports actual certificate ownership.

The main problem seems to have developed due to Danareksa's definition of sales to the "public." The company consistently reports certificate sales to functional groups such as pension funds and insurance companies as sales to individuals. While it may be understandable that Danareksa certificates are desirable investments for such funds, it is extremely misleading to report such certificate holders as based on the number of people with rights or claims against these institutions. There is a considerable difference between example A and example B below.

Example A.

Danareksa sells 100 certificates to 50 different individuals. Therefore each person (on the average) owns 2 certificates worth Rp. 20,000. There are thus 50 individual people who have a "voting right" in the mutual funds for these certificates.

Example B.

Danareksa sells 100 certificates as follows:

10 certificates to 10 individuals.
60 certificates to pension fund A with 20 members in the pension fund.
30 certificates to insurance company B with 300 policy holders.

In this case, 10 individuals vote certificate shares, one pension fund manager votes 60 certificate shares, and one insurance company financial director votes 30 certificate shares. The 20 pension fund members and the 300 insurance policy holders do not own Danareksa certificates but only have rights against either the pension fund in which they are vested or against the assets of the insurance company as creditors.

Danareksa makes a considerable effort to present statistics in their annual reports which state that in the case of example B, they have actually sold 100 certificates to some 330 individuals! They further break down the ownership by social class of the certificate holder, i.e., civil servants, students, housewives, etc. This is entirely misleading as in reality these classifications fit the membership of various functional groups which are actually the particular pension funds or associations.

Although updated data have not been provided, as of 1985 over 86% of the certificates sold were actually owned by pension funds, institutions and foundations. This means that only 14% is actually owned by separate and distinct individual persons. This is a fairly dismal performance after 10 years of certificate sales.

Certificate holdings by these groups further compound the problems of an active capital market as pension funds tend to hold the certificates until maturity once purchased. It is obvious that Danareksa has not fulfilled one of its major objectives - the distribution of share ownership to the populace. This concentration of sales of Danareksa certificates is further excerbated by the fact that most of the certificate holders are actually government pension funds or the national social security system.

When one considers that several of the companies with listed shares and all of the companies which have issued bonds are government owned as well, it is apparent that these transactions actually complete a vicious circle. It can be argued that the sale of government paper, through a government agency to another government company, is actually an open printing press for local currency circulation. Without debating macro-economic theory, such a policy seems to be inflationary and self destructive to the budgetary process.

In order to properly and effectively distribute the benefits of capital market participation to the general public, Danareksa must undertake a major re-structuring of its marketing philosophy and sales distribution systems. A number of actions can be undertaken to shift the majority ownership of Danareksa certificates away from government institutions towards the general public. However, one must also realize that there are a number of interdependent factors which affect the marketability and desirability of Danareksa certificates. There is a very large component of investor education involved in this situation as well.

According to Danareksa, it is possible to purchase their certificates through the nation-wide network of state banks. There appears to be a considerable gap between theory and reality in this matter. Currently over 78% of all certificates are held within the city of Jakarta, with the next highest concentration in the industrial area of West Java. A revised marketing plan and system of incentives must be devised to stimulate sales through the bank branch network. Obviously, banks will be reluctant to sell Danareksa certificates to their customers who are potential depositors. Perhaps a commission-based sales incentive program can be created in conjunction with the placement of a Danareksa employee or representative in selected branch locations.

It is recommended that further study be undertaken to examine the possibility of creating a series of company sponsored employee benefit plans in which employee contributions are matched at some ratio with all funds invested in Danareksa certificates held in each employee's name. This would be a type of contributory savings plan which would accomplish the desired certificate distribution goal.

5.4 DANAREKSA ACCOUNTING PRINCIPLES

The third major area in which Danareksa has significant problems is in its accounting policies and financial reporting practices. The company has failed to follow consistent and generally accepted accounting practices, particularly in its published annual reports. Compounding this problem is the fact that the actual availability of financial data to the public (including potential investors) is extremely delayed - sometimes more than 18 months. It is fair to state that the published financial statements of Danareksa do not accurately report the company's earnings or financial position and are generally so untimely as to be virtually useless to the investor.

The primary accounting irregularities observed include:

o A gross over valuation of investment assets which continues to be reported at the original purchase price. A brief analysis shows that shares held should be written down by at least 18% to reflect actual current market value.

o The mixture of accrual and cost accounting methods in such a manner as to inflate the balance sheet (interest and dividend receivables as current assets without any corresponding dividend payment liability) generally makes the company appear stronger than it is.

o Failure to report dividend payments on certificates issued as an operating expense overstates reported profits by more than 95%. Due to the structure of Danareksa certificates which guarantee a minimum dividend payment equal to the one-year bank deposit rate, the company cannot "declare" a dividend payment after year-end closing. They must show the actual dividend payments made during the year as an operating expense. There is no real option to paying this dividend even if the "final" dividend amount must be approved by the Ministry of Finance. The management of Danareksa consistently reports record earnings when in fact they are using gross income (less minimal overhead expenses) figures.

o There is a combination of misleading data and omission of relevant information in the published financial statements. The internal accounting systems of the company appear capable of producing accurate and relevant financial data easily. However, there seems to be an overt policy by management to present only the most beneficial picture of Danareksa possible. This type of misrepresentation only compounds the problems of developing a free trading and dynamic capital market in Indonesia.

The following recommendations regarding Danareksa's accounting practices and financial reporting are offered:

o Require P.T. Danareksa to utilize the services of an independent, private sector accounting firm for the preparation and publishing of all financial reports. This work should be awarded on a bid basis and the Ministry of Finance should send out a request for such bids to all major accounting firms licensed in the country as soon as possible.

- The government accounting office (BPKP) can continue to examine and audit Danareksa for the purpose of reporting on its internal procedures and its compliance with government budgetary and operational policies.

- Require Danareksa to publish quarterly financial reports to the public. These need not be audited financial statements but should contain relevant updated financial performance information. Danareksa has a fiduciary responsibility to disclose its financial performance to its investors in a timely fashion. In this respect Danareksa is similar to a state bank.

- Commission an in-depth cash flow analysis of Danareksa's operations with the goal of determining the actual depth and strength of its finances. This analysis should also include financial projections with several different scenarios, including the case for writing down the investment portfolio, establishing loss reserves, and charging management fees and commissions on the funds administered.

- Audit the investment and financial reporting policies of the company with the goal of correcting inconsistancies, properly valuing the portfolio, and establishing true and useful reporting procedures.

It is important that the above criticisms and recommendations not be interpreted as a condemnation of the work of individual members of the accounting staff of Danareksa. On the contrary, they have done an excellent job in providing relevant data. It appears to be a management decision to present the financial reports is such a manner as to include the inconsistencies and errors cited above.

5.5 CONCLUSIONS/RECOMMENDATIONS

In addition to the three main problem areas discussed above, P.T. Danareksa requires a number of administrative and policy adjustments in order to place itself in a more positive role within the capital market. Again, some drastic re-adjustments must be undertaken in the operation of Danareksa if there is to be any possibility of future development of the capital market in Indonesia. Much work needs to be done in many areas, but the current position and dominance of Danareksa is a major obstruction in the "path of progress."

With the impending change in senior management, the timing is right for the establishment of a working committee, convened by the Ministry of Finance, to study and develop a long-range strategic plan for the future operations of Danareksa. This committee, which should include interested parties from the private sector, should have a specific mandate to design and implement structural changes (including those recommended herein) in the role of P.T. Danareksa.

Table 17 outlines a number of recommended actions to be undertaken by Danareksa over the next nine months to one year.

TABLE 17: RECOMMENDATIONS FOR P.T. DANAREKSA

IMMEDIATE ACTION (1 MONTH)

A) Delay issuance of DANA Umum Certificates Series F until further study is done on alternative structure.

B) Establish working committee on Danareksa to develop long-range strategies and implementation of recommended structural changes.

C) Issue M.O.F. decree requiring Danareksa to utilize services of private accounting firm. Send out requests for bids from accounting firms.

D) Commission internal analysis of Danareksa portfolio with goal to determine saleable investments and financial impact of "mark to market" of share portfolio.

E) Commission an independent study to analyze Danareksa on a cash flow basis and to quantify amount and impact of GOI subsidy of the company.

F) Begin an in-depth review of the structure and the terms and conditions of Danareksa certificates as well as the marketing procedures currently utilized.

G) Issue a decree which specifically limits the role of Danareksa as underwriter in primary market. Decree should also specifically allow for competition with Danareksa by permitting other companies to issue mutual funds as well.

MEDIUM-TERM ACTIONS (3-6 MONTHS)

A) Begin implementation of new structure for Danareksa certificates with new issue (Series F) which could include new features such as variable rate of return based on actual share performance.

B) Begin re-structuring of Danareksa certificates to perform more like true mutual funds. Adjust dividend pay-out rate as applicable and consider re-purchase/re-sale program to more evenly distribute certificates.

C) Negotiate and structure an asset swap of share and bond holdings with NBFIs for medium-term (3-5 years) NBFI promissory notes, in coordination with new ministry decree allowing NBFI companies to compete with Danareksa for their own mutual fund issues.

D) Obtain the services of a private sector technical advisor to work directly with President of Danareksa on a long-term basis. Possible assistance from USAID for personnel identification and funding should be pursued.

E) Hire private sector accounting firm to prepare Danareska financial reports.

F) Receive status reports from working committee.

LONG-TERM ACTIONS (9 MONTHS - 1 YEAR ONWARDS)

A) Complete revision of system and financial reporting procedures. Publish interim financial report.

B) Take appropriate action ón various matters as recommended in studies and analysis reports requested.

C) Consider re-structuring GOI loan to Danareksa, including an option to accept a write-off against accounting loss on share portfolio. GOI loan balance has steadily increased to Rp 55 billion level as of 12/31/86.

D) Study benefits of removing Danareksa from real estate business through sale (and possible lease-back) of new building.

E) Commission a study to analyze the benefits of selling a percentage of Danareksa shares directly on the stock market. A partial public offering of shares would raise new capital to offset losses against net worth for share write down. Also, partially privatize Danareksa, could positively influence overall capital market development.

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ANNEX F

UNCLASSIFIED STATE 237993/01

ACTION ECON 3 INFO AMB DCM FAS POL PCS AID USIS RA CHRON 11

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E.O. 12356: N/A
TAGS:
SUBJECT: FINANCIAL MARKETS PROJECT (497-0363); APPROVAL OF PROJECT IDENTIFICATION DOCUMENT

RECEIVED
JUL 1 1988
USAID/C&R
Jakarta

1. SUMMARY: ANE BUREAU PROJECT REVIEW COMMITTEE (PRC) MET JUNE 6, 1988 TO REVIEW SUBJECT PROJECT IDENTIFICATION DOCUMENT (PID). BUREAU COMMENDS INNOVATIVE APPROACH TAKEN BY USAID IN PID FOR FURTHERING FINANCIAL MARKET DEVELOPMENT. AS RESULT OF REVIEW, USAID MAY PROCEED TO PREPARE AND APPROVE THE PROJECT PAPER (PP) AND AUTHORIZE THE PROJECT IN THE FIELD. APPROVAL AT THIS TIME DOES NOT INCLUDE THE PROPOSED PRIVATIZATION FUND WHICH WILL NEED FURTHER USAID DEFINITION/ CLARIFICATION AND REVIEW IN AID/W. BUREAU ISSUES AND CONCERNS ARE NOTED BELOW. END SUMMARY.

2. PRC MET JUNE 6 WITH USAID REPRESENTATIVES GORDON WEST AND PHIL BREWER. SUBSEQUENT DISCUSSIONS WERE HELD TO CLARIFY THE COURSE OF ACTION TO BE TAKEN FOR THE PROPOSED PRIVATIZATION FUND. REVIEWS GENERALLY APPLAUDED INNOVATIVE APPROACH TAKEN BY USAID TO DEVELOP FINANCIAL MARKETS, AND CONCLUDED THAT WITH THE EXCEPTION OF PRIVATIZATION FUND, THERE WERE NO MAJOR UNRESOLVED ISSUES THAT WOULD REQUIRE AN ANPAC REVIEW. ACCORDINGLY, THE PRC RECOMMENDS AND THE AA/ANE HEREWITH APPROVES USAID PROCEEDING AT THIS TIME WITH THE DEVELOPMENT AND APPROVAL OF THE PP AND AUTHORIZATION OF THIS PROJECT EXCEPTING THE PROPOSED FUND.

3. ISSUES AND CONCERNS REQUIRING USAID ATTENTION ARE:

- A. BUREAU VERY SUPPORTIVE OF ASSISTING INDONESIAN PRIVATIZATION INITIATIVE. HOWEVER, PRC AGREED THERE ARE SEVERAL DESIGN ISSUES TO RESOLVE BEFORE THE PROPOSED PRIVATIZATION FUND CAN MEET SECTION 611 REQUIREMENTS. IN VIEW OF THE INNOVATIVE AND SENSITIVE NATURE OF THE PRIVATIZATION FUND CONCEPT, WE WOULD APPRECIATE THE FOLLOWING ADDITIONAL INFORMATION BEFORE YOU AUTHORIZE THIS COMPONENT: (1) THE MAJOR CONSTRAINT(S) WHICH THE FUND IS INTENDED TO OVERCOME, E.G. LACK OF CREDIT AVAILABILITY, POLITICAL FACTORS, ETC., AND THE RATIONALE OR USING A (

USAID ROUTING		
TO	ACT.	INFO
DIR		✓
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PPS		✓
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ARD		
CPH		
EHR		
EHR/T		
VHP		
PSD	✓	
INFO C		
PER		
DMC		
GSO		
C&R		

THE OBJECTIVES OF THE FUND IN TERMS OF PRIVATIZATION, HOW THIS RELATES TO AGENCY POLICY ON PRIVATIZATION, AND THE EXPECTED END-OF-PROJECT STATUS INDICATORS OF THE FUND COMPONENT OF THE PROJECT; AND (3) MORE DETAILED INFORMATION CONCERNING THE OPERATION OF THE PROPOSED FUND WITH RESPECT TO ADMINISTRATOR (OR TRUSTEE), BUYER, SELLER, SOURCES OF FUNDING, INTEREST RATES, VALUATION RESPONSIBILITY AND PROPOSED PUBLIC SHARE LISTING.

DETAILS ON FUND OPERATION DO NOT NECESSARILY HAVE TO INCLUDE DESIGNATION OF PARASTATALS TO BE DEREGULATED, BUT SHOULD BE DESCRIPTIVE OF THE PROCESS TO BE FOLLOWED AND CRITERIA APPLIED. AID/W ENCOURAGES USAID TO EXPLORE ALTERNATIVES TO A LOAN FUND SUCH AS GUARANTIES OR DISBURSING FUNDS DIRECTLY TO THE GOI WHICH WILL AVOID POSSIBILITY THAT THE PROPOSED LOAN FUND WILL COMPETE WITH LOCAL PRIVATE SOURCES OF FINANCE. BUREAU IS PREPARED TO REVIEW REQUEST TO AUTHORIZE THIS COMPONENT THIS YEAR, HOWEVER, WE NOTE THE TIMETABLE FOR COMPLETING DESIGN AND NEGOTIATION FOR FURTHER AUTHORIZATION ACTION ON THIS COMPONENT BY AUGUST APPEARS TO BE A DIFFICULT TARGET. TO ALLOW ADEQUATE TIME TO PROPERLY DEVELOP AND NEGOTIATE THIS SENSITIVE COMPONENT WE URGE THAT IT BE CONSIDERED FOR AN FY 89 AMENDMENT TO THE PROJECT RATHER THAN ATTEMPTING TO INCLUDE IT IN THE 1988 PACKAGE.

- B. PRC WAS NOT CERTAIN OF THE PROPOSED PROJECT LINKAGES OF INPUTS TO OUTPUTS, OUTPUTS TO PURPOSE AND THE PURPOSE SUPPORT OF THE STATED GOAL. FOR EXAMPLE, IT WAS NOTED IN THE MEETING THAT WHILE EMPLOYMENT GENERATION WILL REMAIN A GOAL, THE PROJECT'S IMPACT ON THAT GOAL SHOULD BE CLARIFIED TO IDENTIFY FACTORS OTHER THAN EXPANDING SMALL AND MEDIUM SIZED ENTERPRISES AS THE PROJECT'S MEANS OF SUPPORT FOR THE GOAL. PP SHOULD HAVE A CLEAR DISCUSSION OF PROJECT LINKAGES SHOWING HOW EACH COMPONENT FITS WITHIN THE WHOLE.

- C. PRC OBSERVED THAT PROJECT APPEARS TO BE RATHER AMBITIOUS AND BROAD IN SCOPE, COVERING STOCK, BOND, MONEY AND COMMODITY MARKETS, AS WELL AS PRIVATIZATION ASSISTANCE. IT WAS SUGGESTED THAT THESE ELEMENTS OF THE PROJECT BE PRIORITIZED, GIVEN THE LIMITED AMOUNT OF AID RESOURCES BEING PROVIDED. DURING PP DEVELOPMENT YOU MAY DECIDE TO FURTHER LIMIT COMPONENTS TO A SMALLER GROUP OF CORE ELEMENTS DURING THE INITIAL STAGE OF THE PROJECT. ALSO, PP SHOULD FURTHER DEFINE WHAT THE POLICY ENVIRONMENT IS AND HOW THE PROJECT WILL HELP ENSURE THAT THE POLICY AND INSTITUTIONAL REFORM AGENDA WILL BE ACCOMPLISHED. THE PP SHOULD CLARIFY BASIS FOR ASSUMING THE LEGAL AND REGULATORY PROVISIONS WILL BE IN PLACE TO BE

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PERMIT EACH MARKET TO FUNCTION IN A FREE MARKET ENVIRONMENT. THE MISSION SHOULD ALSO ENSURE THAT LOP FUNDING, TECHNICAL ASSISTANCE AND OTHER RESOURCES TO BE PROVIDED ARE SUFFICIENT TO ACHIEVE THE PROJECT PURPOSE AND END OF PROJECT STATUS INDICATORS GIVEN THE AMBITIOUS NATURE OF THIS UNDERTAKING. AS WAS RAISED IN THE NPD CABLE, THE MISSION MAY CONSIDER GREATER USE OF SHORT-TERM T/A TO REPLACE SOME LONG-TERM T/A TO TARGET INDIVIDUAL POLICY ISSUES AND CONSERVE FUNDS. THE OTHER ISSUES RAISED IN THE NPD CABLE SHOULD ALSO BE ADDRESSED IN THE PP.

- D. SPECIFIC PROJECT ACCOMPLISHMENTS AND MEANS OF MEASURING OUTPUTS IN QUANTITATIVE AND QUALITATIVE TERMS SHOULD BE CLARIFIED IN THE PP. WHILE UNDERSTANDING THAT CAPITAL MARKETS REFORM IS A LONG-TERM AGENDA, THE MISSION SHOULD ENSURE THAT OBJECTIVES EXPECTED TO BE ACCOMPLISHED DURING THE PROJECT ARE CLEARLY STATED AND QUANTIFIABLE INDICATORS OF PROGRESS ARE SET FORTH IN THE PP.

- E. BENEFICIARY IMPACT ANALYSIS IN PP SHOULD DEMONSTRATE THAT MAJOR CAPITAL MARKETS REFORM PROGRAM WILL NOT AGGRAVATE EMPLOYMENT SITUATION OR IMBALANCES IN INCOME DISTRIBUTION. BOTH THE PP AND PROJECT CONSULTANT SCOPE OF WORK SHOULD CITE THE NEED TO DETERMINE WHAT

REGULATORY OR STRUCTURAL SAFEGUARDS MAY BE APPROPRIATE TO PREVENT ABUSES OF THE SYSTEM OR TO ENCOURAGE RECRUITMENT OF NEW INVESTORS TO THE MARKET. BENEFICIARIES SHOULD BE CLEARLY IDENTIFIED, AND THERE SHOULD BE A SUBSTANTIVE ANALYSIS OF THE ROLE OF WOMEN AND LOCAL ETHNIC GROUPS IN FINANCIAL MARKETS IN THE SOCIAL SOUNDNESS ANALYSIS. SHULTZ
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ANNEX G

INITIAL ENVIRONMENTAL EXAMINATION OR CATEGORICAL EXCLUSION

Project Country: Indonesia

Project Title
and Number: 497-0360 - Financial Markets

Funding: FY 1988 through FY 1993
Grant: $12.0 Million

IEE/CE Prepared By: Joseph M. Carroll, Office of Private Sector Development, USAID/Indonesia

Environmental Action Recommended:

Positive Determination ____________

Negative Determination ____________
or
Categorical Exclusion X

These activities meet the criteria for Categorical Exclusion in accordance with Regulation 16, Section 216.2(c) and are excluded from further review because they fall within criteria 2(i), 2(iii) and 2(x).

(Refer also to attached justification.)

Action Requested By: David N. Merrill Date: 5/5/88
David N. Merrill
Mission Director

Concurrence: Donald [illegible]
Mission Environmental Officer

Approved: X

Disapproved: ____________

Date: 5-5-88

Clearances: LO:PScott (Draft)
PSD:GWest [illegible]

A. Project Description

The Financial Markets Project (497-0360) is a six year, $16 million project whose goal is to promote growth of the private sector in Indonesia. The primary purpose of the project is to provide the assistance required to develop the capital market in Indonesia so that private enterprises will have access to long-term financing. Assistance will also be provided to encourage further liberalization of the market, including deregulation of SOEs.

In the area of capital market development, A.I.D. will support the policy reforms initiated by the GOI by providing the technical assistance and training needed to carry out policy changes effectively. This activity will also include support to investor education and promotion campaigns.

With regard to deregulation, A.I.D. will address the need for assistance to DANAREKSA, the GOI mutual fund, in its conversion to private investment management. Other deregulation activities will include deregulation of municipal finance to permit municipalities to raise their own revenues and issue bonds.

B. Identification and Evaluation of Environmental Impact

The impact of this project on the environment is likely to be slight in overall magnitude and essentially indirect. The policy dialogue, technical assistance and training components will have no direct impact on the physical environment. Assistance to be provided to DANAREKSA will be used to develop a private investment management capability and will not be used to finance directly the activities of any one company. The capital markets developed in this project will provide funds for individual projects of a diverse nature in which individual companies invest. However, A.I.D. will not retain review and approval authority over the activities of those companies or other uses of funds obtained through the capital market. Because the proceeds will not be used for the purpose of carrying out specifically identifiable activities, no further environmental review is possible or necessary.

C. Recommended Environmental Action

On the basis of the discussion above, it is recommended that the policy dialogue, technical assistance and training components be categorically excluded from further environment review pursuant to A.I.D. Regulation 16, Paragraph 216.2(c)(2)(i) and (iii). It is further recommended that the local currency loan assistance activities be categorically excluded from further review pursuant to A.I.D. Regulation 16, Paragraph 216.2(c)(2)(x). Because the loan proceeds represent contributions by the U.S. to an institution which is not carrying out specifically identifiable activities, neither an Environmental Assessment nor an Environmental Impact Statement is required.

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