

Indonesia

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Executive Summary

Easy access to offshore funding in the past has been the main reason for the current state of the Indonesian bond market. It is shallow, relatively illiquid, and lacks government securities aside from Central Bank and state-owned enterprise (SOE) papers.

The fact that bond market financing is a relatively new development in the financial sector accounts for the lack of a long-term interest rate benchmark resulting, furthermore, in a shallow market. Meanwhile, the corporate bond market, on the buy-side, is fragmented, led by a few large institutions, and has only recently been supplemented by the growth of mutual funds. On the supply side, relatively few good names have issued papers, as most firms traditionally found it more beneficial to tap the offshore market.

Other issues that have impaired the market include weak enforcement of disclosure rules and uneven market information. Both have made assessing credit problematic. The legal framework, in addition, needs a major revamp. Investor protection, the ease of transfer of property titles and legal recourse—especially in the areas of bankruptcy, dispute resolution, and contract enforcement—all leave much to be desired at the moment.

The Asian crisis was both a blessing and a curse for Indonesia. While it wrought havoc on the social fabric of the country, it also—in terms of the bond market—revealed weaknesses and provided impetus for development.

During the worst period in 1998, gross domestic product (GDP) growth declined by 13.7 percent. The rupiah depreciated significantly, triggering massive defaults by Indonesian firms, which had borrowed unhedged foreign currency-denominated loans. Unemployment rose sharply and consumer prices shot up by 58.2 percent, creating widespread social unrest. President Habibie provided assistance to the corporate and banking sectors with a variety of new restructuring programs, such as the

Jakarta Initiatives (JI) and new agencies such as the Indonesian Bank Restructuring Agency (IBRA) and the Indonesian Debt Restructuring Agency (INDRA).

As part of the government's effort to recapitalize the banking system, which was overwhelmed by bad loans, the Ministry of Finance (MOF) started to issue bonds in 1999. The total amount as of November 1999 was 425 trillion Indonesian rupiah (Rp425 trillion) split into Rp218.3 trillion issued to the Central Bank (Bank Indonesia/BI), and the rest to commercial banks. Bonds issued to BI are designated to refinance liquidity support given to the banking system during the height of the crisis (mainly between November 1997 and May 1998). After several delays, bank recapitalization began in May 1999 with the bond issuance. Another issuance came in October and more are expected to further recapitalize Bank Mandiri and the other state-owned banks (Bank Negara Indonesia [BNI], Bank Tabungan Negara [BTN], and Bank Rakyat Indonesia [BRI]), to bring the total to around Rp620 trillion.

Bonds issued as part of bank restructuring consist of variable-rate and fixed-rate bonds, designed to strengthen the capital base of commercial banks, and inflation-indexed bonds, issued to refinance liquidity support. The variable-rate bonds were used to raise recapitalized banks' capital adequacy ratio (CAR) to zero, while the fixed-rate bonds were used to raise it further to 4 percent. Given the massive amount of bad debt in the banking system, it is expected that the amount of variable-rate bonds far exceeds that of their fixed-rate counterparts. Three potential problems arise from this situation. First, the majority of government bonds already issued cannot be used for the purposes of creating a benchmark yield curve. Second, any plans to replace SBIs (the Central Bank money market instrument) with government bonds will run into technical difficulties, as the bonds' coupon rate is tied to three-month SBI rates. And third, the current SBI rates are too low to offer the investment community significant returns, which makes tradability somewhat unlikely.

Due to the conditions surrounding the bonds' design and timing of issuance, the government has put high priority on the trading mechanism of recapitalization bonds. At the moment discussions are still under way, especially on relative advantages of over-the-counter (OTC) versus exchange trading, although there are indications that both will be used. Given the potential amounts to be traded, the Central Bank is clearly in the best position to perform registration, clearing, and settlement. Another issue that has hindered trading is the absence of sufficient informative documentation, such as a prospectus.

The lack of legislation guaranteeing payment of both interest and principal has not helped either. Under the current scheme, the Government

has to seek parliamentary approval for its annual budget, including its annual obligations to bondholders. In the absence of a legislated guarantee, the market will require at the very least a coherent debt management plan encompassing several budget years.

The consequences of the government's willingness to issue bonds on a high interest rate regime raise the problems of yield dichotomy between various government and corporate bonds. Some outstanding corporate bonds, such as HM Sampoerna (HMSP), Astra Sedaya Finance (ASDF), and Astra Agro Lestari (AALI) offer more attractive yields (around 17 percent), with tolerable risk (AA and A rating), whereas five-year government bond coupons offer only 12 percent. SBI one-month rates meanwhile achieved 13.55 percent and the three-month rate was 13.29 percent as of 23 August 2000. As of 20 July 2000, the estimated yield for Indonesian bonds denominated in US dollar was 12.81 percent in US dollar or 19.5 percent in rupiah. Meanwhile, rupiah fixed-rate bonds were offering a yield of only 12.62 percent (in rupiah—assuming the price is set at 98).

Policy Recommendations. The infrastructure of the market and characteristics of the instruments must be improved. In market infrastructure, improvements must be made in transparency, trading efficiency, and the clearing and settlement process. Low liquidity in the current secondary corporate bond market can be attributed to low market transparency together with a weak settlement process. Key areas for attention are (i) trading system and information (establishment of a market-making system); (ii) establishment of a repurchase (repo) market; (iii) clearing system; (iv) establishment of real time gross settlement; (v) enactment of legislation on government bond issuance, and (vi) establishment of a debt-management function.

The characteristics of the instruments must be improved ultimately to create a risk-free yield curve as a pricing benchmark for fixed-rate instruments. Key areas are (i) issuance process and procedures, (ii) timing, (iii) tax considerations, and (iv) introduction of other government paper.

Overall, these efforts could create a more liquid market while improving transparency and trading efficiency.

Trading Systems and Information. The Central Bank should be the first choice for handling registration, clearing, and settlement of government bond trading. Nevertheless, once the capability of the securities exchange and its clearing and settlement agencies have been upgraded, their participation should be considered as a way of maintaining

“contestability.” Trading of bonds usually requires the creation of a market-making system and an interdealer market to generate liquidity.

Establishment of a Repurchase Market. Government bonds are widely used as a monetary management instrument. The Central Bank’s basic interest in acting as a super dealer is to maintain monetary policy through government bonds. This is essential for Indonesia, given that the current interest burden associated with SBIs is tremendous. The Government should start issuing short-term papers to fill in the short end of the yield curve. The Central Bank can then employ a repo mechanism using government securities to move monetary management from direct intervention to signaling.

Establishment of an International-Standard Clearing and Settlement System. The establishment of a clearing and settlement system that meets international standards could contribute significantly to improvements in market liquidity. Electronic scriptless trading should be the first choice, given the amounts involved, the need for speed, and the need for authorities to track the market in real time.

The application of a delivery-versus-payment (DvP) system could reduce the number of disputes over accrued interest. Currently, BI has installed a Real Time Gross Settlement system (RTGS) for settlement, but the system is not accessible to securities houses, since they cannot open an account with BI. This point raises the issue of an uneven playing field for banks and securities houses. The two even have separate central depositories and settlement agents (BI and the Indonesian Securities Central Custody Agency [KSEI]). Even KSEI cannot open an account with BI.

Laws on Government Bond Issuance. The legal framework for issuance of government bonds remains weak, since it is only in the form of a presidential decree (*Keppres*). Under *Keppres*, the issuance of government bonds seems to be restricted only to the current government. The legal framework should include parliamentary approval to reassure investors of timely repayment at maturity.

Establishment of a Debt-Management Function. The Ministry of Finance is in charge of overall policy, including decisions on outstanding amounts, design of the maturity structure, and issuance. It is essential to appoint a unit within the ministry with adequate authority and skilled manpower, especially in the area of trading debt instruments, and to incorporate the debt-management plan into the overall budgetary framework. The budgetary

framework itself should be multiyear to allow flexibility that includes the size of the future debt burden and plans for deleverage.

Timing of Trading. A timely start for trading on government bonds could help add liquidity to some of the largest banks, the most important conduits of liquidity. The unevenness of aggregate liquidity in the system has contributed to the deadlock in the credit market. Adding liquidity into recapitalized banks can conceivably help break this deadlock, but given the current size of the bond market it would not be prudent to increase supply with large amounts suddenly.

Issuance and Trading. It is essential to publish and adhere to an announced issue calendar with a schedule designed to minimize liquidity fluctuations. The main advantage would be lowered issuance cost and increased liquidity. There is probably no procedure to identify the optimal auction method, so experimentation is called for. In the first instance the Government might consider a sealed-bid, uniform-price auction method, however.

Tax Considerations. More and more countries have abandoned transaction taxes to remove the wedge between seller and buyer prices, resulting in better liquidity. The Government should carefully consider the benefits to be foregone from collecting taxes and the benefits of having a deep and liquid sovereign bond market with its attendant positive externalities.

Other Types of Government Bonds. For the long-term development of the bond market, the Government should consider the housing market as an additional source of supply. Some Asian countries have also created development banks for long-term infrastructure projects, which fund their activities by tapping the bond market. These bonds are government-guaranteed, giving them quasi-sovereign rating and favorable pricing. Subsidies, when necessary, can take the form of a lump sum injected directly into the projects under a competitive scheme, rather than as loans to government entities. This ensures credibility and the appropriate channeling of scarce financial resources. Other types of quasi-government bonds include regional government bonds that are also guaranteed by the (central) government.

Suggestions for Further Studies. The nature of the financial market, with its overreliance on short-term investments, needs to be corrected gradually, and the government's own plan to ease the debt burden in the

medium term needs to be studied. Related to this is the issuance strategy to minimize the cost to the Government.

Two issues need to be addressed within the larger framework of bond market development: (i) a mechanism to ensure harmonization of fiscal and monetary policies, and (ii) the issuance of regional government bonds, which relate not just to recapitalization bonds, but also to the long-term development of the government bond market and, more generally, the whole bond market.

This paper does not discuss the potential for trading the current recapitalization bonds internationally under a “Brady-type” arrangement, or the framework under which such trading could be done. At this stage, the Government has relied only on the Paris Club to seek rescheduling of its foreign debt. There are no plans to expand the process into restructuring beyond rescheduling. It is not inconceivable, however, that expansion will ensue if the total debt burden of the Government—domestic and offshore—becomes unbearable. When governments start tapping the international market, even under a distressed-debt situation like the Brady Plan, they generally find they must impose some additional disciplinary measures in terms of economic management. Such a change would certainly be counted as an advantage in this case. In addition, these measures would prepare both the Indonesian Government and its corporate sector to use the international market for “normal” (non-Brady) financial leverage.

I. Fiscal Policy and Management

A. Budgetary Planning

The Ministry of Finance (MOF) is the most powerful institution in the Government. The Minister is the Chairman of the Monetary Board of the Central Bank, and as such is in charge of macroeconomic management. The Monetary Board coordinates fiscal, monetary, and balance-of-payments policies and their implementation.

The MOF also represents the Government as the owner of state-owned enterprises (SOEs), issues “guidance” to financial institutions, and supervises the capital markets. The MOF consists of six powerful directorates and authorities: Customs and Excise, Taxation, Budgeting and Treasury, State-Owned Enterprises, Financial Institutions and the Capital Market Executive Agency (PT Badan Pengawas Pasar Modal, or BAPEPAM).

The MOF plans and prepares the budget, while the National Planning Agency (BAPPENAS) shares responsibility with the MOF for the

development budget. They submit the draft budget to the Parliament (DPR) in January of each year for approval. The budget is authorized by the parliament, which passes it into law. However, the influence of the DPR in the budgetary process is traditionally considerably less than in other countries, because the draft budget only allocates expenditure by sectors and not by programs or projects. Therefore, the DPR is unable to scrutinize any particular detail, especially for development expenditure. There is every indication that the current parliament will try to overcome this shortcoming.

Execution of the budget is the responsibility of the Government. The MOF, although remaining the major player, shares responsibility with BAPPENAS for development expenditure.

The State Audit Board (BPK), which reports to the Parliament, supervises budget execution. Only the BPK has authority to approve the annual financial reports for budgetary accounts before they are submitted to the Parliament. The Government does budgetary accounting, but final approval rests with the Parliament.

B. Government Revenue

The balanced budget policy adopted in 1967 prohibits the Indonesian Government from issuing any domestic government bonds for deficit financing. The purpose of this policy is to discourage the Government from running budget deficits. Government inflows therefore have traditionally come only from taxation, the sale of oil and gas, and program aid granted by the Consultative Group of Indonesia, a group of developed country lenders under the auspices of the World Bank. Occasionally, the Government taps the offshore syndicated loan market. Minor mismatches between revenue and expenditure are sometimes covered by the issuance of SBI (Central Bank securities).

C. Financing Fiscal Deficits

Despite their reduction in percentage terms, the absolute level of offshore loans continues to rise, indicating inability to reduce dependency on foreign loans to cover the budget deficit, particularly the development budget. The increase in offshore borrowing also indicates that the Government has been either unable or unwilling to use the domestic capital market as a source of development funds. This meant that when the financial crisis struck Indonesia, debtors, including the Government, faced a major challenge in servicing forex-denominated loans (whether borrowed on or offshore).

Domestic entities that borrow offshore include not only the central government, but also the regional governments and regional government enterprises (e.g., regional water enterprises, which are among the largest holders of long-term foreign loans). Offshore loans are channeled to the regional governments or enterprises through the central government, which acts as a guarantor. This mechanism is called a two-step loan. Two-step loans have accounted for almost half of total government offshore loan borrowing.¹ The availability of this type of funding has resulted in reluctance among regional governments to tap the domestic financial market, particularly as this entails a complicated process. For a start, to issue a municipal bond, the entity has to undergo a rating process and be audited by public accountants. A central government guarantee for offshore loans, however, is provided without cost, and has no penalty mechanism that can be invoked in the event of delinquency.

Nevertheless, several regional development banks (Bank Pembangunan Daerah/BPD) have issued bonds, although they have not sold them in the open market.² Instead, the bonds are sold in “private placements” outside the exchange, indicating that government entities are not ready to adopt capital market standards.³

An additional reason for the absence of state and regional government enterprises from the stock and bond markets, especially from the 1970s to the early 1990s, was the government’s capital participation in state enterprises through the national budget, and in regional enterprises through the regional budget, and its provision of subsidized loans to both state and regional enterprises.

In addition, regional governments in the past did not seek to diversify their funding sources, as their budgets were subject to central government approval. Therefore, in accounting terms, regional government budgets essentially exist only as a bookkeeping device for registering revenues and expenses. Municipal bond issuances could become important in the near future, as the central government budget comes under increasing pressure.

1. Municipal Finance Project, *Perkembangan Keuangan Perusahaan Daerah Air Minum (PDAM): Ringkasan Eksekutif* (Jakarta: Research Triangle Institute, December 1992).

2. These regional banks include BPD Aceh, BPD Sumatera Utara, BPD Sumatera Barat, BPD-DKI Jakarta, BPD Jawa Barat, BPD Jawa Tengah, BPD Jawa Timur, BPD Sulawesi Utara, and BPD Nusa Tenggara Barat.

3. Ministry of Finance of the Republic of Indonesia, *Analisa Atas Pelaksanaan Pinjaman Daerah* (Jakarta: Bureau of Regional Finance, February 1995).

D. Provision of Investible Funds in the Absence of a Debt Market

When oil prices fell, and it became clear that the government alone could not bear the burden of providing investible funds, private sector participation was encouraged through the liberalization of the real and financial sectors.

Of special importance to mobilize investible funds was the enactment of Law No. 7 on the Banking Sector in 1992, which allowed the establishment of banks with only Rp500 million in paid-up capital.⁴ Within a short period the banking sector started to grow tremendously, and with hindsight, uncontrollably. Many banks offered very high interest rates to attract deposits. In turn, most banks placed funds in other banking and investment businesses, in a classic case of moral hazard.

Growth in investible funds allowed by the policy, along with other favorable factors, was responsible for Indonesia's commendable growth rate in the past two decades. High growth, combined with a relatively open economy and the prevalence of oligopolistic and monopolistic practices, attracted huge surges of capital inflow in the form of foreign direct investment (FDI), bank lending, and capital market investments. A substantial portion of the borrowing was left unhedged and lent to long-term projects. The rest of the funds were deposited in rupiah with local banks that gave substantial margins due to high domestic deposit rates.

Underdeveloped debt markets in all the afflicted Asian economies, not least Indonesia, contributed to the severity of the downturn. At the very least this meant there was no means of cushioning the sudden loss of investor confidence. Before the crisis, it was common knowledge that most banks in the region suffered from maturity gaps because of the widespread practice of using the short-term deposit base to fund longer-term lending. The lack of a deep and liquid domestic debt market made it difficult for banks to hedge their exposure.

Prior to the crisis, to mitigate their risk exposure, many banks in Indonesia used floating interest rates to structure their loans. This led to the false argument that their interest rate risk was naturally hedged. In fact, it led to many borrowers becoming insolvent, which quickly turned a liquidity crisis into a crisis of insolvency.

Furthermore, many banks relied heavily on offshore borrowing to finance domestic lending. In many cases domestic banks lent to Indonesian borrowers in US dollar, especially for office and other commercial real estate construction. The developers then quoted rents in US dollar,

4. Equal to about US\$250,000, using the period's exchange rate of about Rp2,000 per US\$.

believing that their foreign exchange (forex) loans were thus naturally hedged against fluctuations in the currency and also that the banks were similarly protected. As with interest risk, currency risk during the crisis quickly turned into a credit risk and eventually to insolvency.

In this situation, a deep and liquid domestic debt market would have provided the function of a “shock absorber.” During periods of capital inflow, a well-functioning debt market would have channeled the funds to minimize the maturity gap. This process, in turn, would have dampened the shock of a sudden reversal in capital flows.

II. Monetary Policy and Management

Bank Indonesia (BI) is the Central Bank of Indonesia. It implements monetary policy by regulating credit in the economy, using discount facilities and open-market operations (OMO). BI supervises and regulates all financial institutions with the exception of investment, insurance, and development finance companies. Being the sole issuer of the country’s bank notes, it also regulates the country’s foreign reserves, and is the lender of last resort to the banking system. Under the new Central Bank Law, BI has two main mandates: (i) stabilization of the currency in terms of international competitiveness (the exchange rate) and domestic purchasing power (inflation), and (ii) maintenance of the national payments system.

A. Monetary Policy Tools

Despite improvements in the budgetary system, especially following tax reform in 1984, Indonesia still relies on monetary policy for economic stabilization. The main thrust has been control of money in circulation and banking credit. The tools employed have been the reserve requirement and OMO. The banking sector remained under tight Central Bank control until 1992, when the enactment of the Banking Law made it easier to establish new banks.

The main monetary instruments for OMO are the BI papers, the Central Bank Securities (SBI) and the promissory notes issued by local banks endorsed by BI (SBPU) (see *Types of Instruments* in Chapter 4 for a full description). By using both instruments, the BI is able to directly affect money supply as well as the interest rate, and to indirectly affect the exchange rate. SBIs were heavily used from December 1997 as part of a tight monetary stance, and as a means of applying the brakes to currency depreciation. During this period, BI increased the SBI rate from 17.38 percent in December 1997 to over 60 percent in September 1998. Savings and deposit rates rose in tandem with the rise in SBIs, from

23.92 percent in December 1997 to 69.17 percent in September 1998. The volume of SBIs also rose, from Rp16.9 billion at the end of 1997 to Rp40 billion in October 1998. In addition to SBIs, BI also uses the SBPU, which can be categorized as a form of liquidity support. During the period of monetary tightening, SBPU trading was stopped.

During the crisis, BI continued to use interest rate policy to stop the currency slide, which had some measure of success. However, BI was quite late in raising rates, and then it did not keep them high long enough, especially during the critical period of September to December 1997. It can be argued that at the time BI was not independent of government influence.⁵ Gradually interest rates went back down to around 11 percent to 12 percent in November 1999.

B. Monetary Policy Implications of the Asian Crisis

Until the enactment of the 1992 Banking Law, which liberalized the establishment of banks, the banking sector remained under tight Central Bank control. The banking system underwent severe liquidity pressure during the crisis, then subsequently went into a period of insolvency due to the tremendous cost of bad loans. Only a few of the larger banks had capital adequacies above the minimum 4 percent specified by the Central Bank. Most of the largest banks had to be recapitalized. The damage to the banking system was even more severe prior to recapitalization, due to the negative interest margin they suffered during the high interest rate episode. Delays in recapitalization added to the damage.

Currently, most of the banking system has been restructured. Banks whose owners could not come up with the necessary new equity were either closed or taken over by the Government. However, the credit market to date has not recovered, creating excess liquidity in the banking system. This is mainly attributable to banks that have not been recapitalized and cannot yet channel credit on a massive scale. The deadlock in the credit market is due to the inability to distinguish "good" from "bad" borrowers. In addition, most of the largest corporations in the country have yet to settle their outstanding credit with the Indonesian Bank Restructuring Agency (IBRA). The fall in collateral value also added to the problem. Furthermore, the fluctuating exchange rate and uncertainties regarding interest rates make pricing a difficult exercise.

To absorb the excess liquidity in the banking system, BI has had to increase its SBI volume significantly, incurring high interest costs. To

5. BI was given independent status in mid-1999 with the new Law No. 23, 1999.

alleviate its own interest costs—and at the same time lower interest rates to lower banking lending costs—the Central Bank has lowered SBI interest rates significantly. Banks have had to accept the lower income from placement in SBIs because other avenues to channel their excess liquidity are practically non-existent in the clogged credit market. In turn, banks have also lowered the interest rates paid on deposits to avoid negative interest margins.

In line with its new Central Bank Law mandate of stabilizing currency and inflation and maintaining the national payments system, BI has transferred its program loans to several state banks. It is also currently looking into divesting its equity holdings in several banks and investment firms.

III. Overview of the Bond Market

There are several main reasons for the sluggish development of the debt market in Indonesia. First, as with the rest of the financial market, reporting standards are inadequate and there is a plethora of cross-shareholding and cross guarantees, making credit assessment difficult. The alarming scale of this problem came to light when it was discovered that even the Central Bank did not have adequate records on the actual extent of Indonesian corporations' external debt. Second, despite the virtual currency peg to the US dollar, the authorities did not feel comfortable letting global events dictate the fate of the economy. Third, the Indonesian Government felt until recently that relying on domestic debt would not be in the best interests of fiscal discipline, and easy access to bilateral and multilateral aid encouraged government complacency.

However, faced with having to carry out a costly bank restructuring effort, the Government has had no recourse but to issue domestic debt instruments (although they have not yet been released to the secondary market). It has also hinted that in the future it will reduce its reliance on foreign borrowing and start to tap domestic financial sources. To facilitate this and develop the domestic financial market further, measures to ensure adequate liquidity are crucial.

It is instructive to put the local bond market in perspective. Bond market capitalization has never exceeded 2 percent of the total outstanding stocks, bonds, and SBIs between 1993 and the present, except in 1997. That year saw the launch of 11 new bonds, the highest figure ever, with the total capital raised amounting to Rp6.3 trillion. In fact, that year—especially the first half—on the eve of the financial crisis, was when the bond market really picked up. After the effects of the crisis kicked in and interest rates rose, the market slowed down considerably.

It should be noted that several bonds are technically in default, although they have not been delisted. Tables 1 and 2 offer a summary of activity in the stock and bond markets.

TABLE 1
Financial Market Summary
(Rp trillion)

Market Value, End of Period	1993	1994	1995	1996	1997	1998	June 1999
Bank Loans	150.3	188.9	234.6	292.9	378.1	487.4	251.3
Bond Market Cap	4.7	4.9	6.4	8.9	15.2	13.9	13.4
Stock Market Cap	69.3	103.8	152.2	215.0	159.9	175.7	416.1
SBI Outstanding Volume	23.3	15.1	11.9	18.6	14.9	58.8	50.0
GDP (current)	329.8	382.2	454.5	532.6	627.7	942.8	561.5
GDP (constant 1993)	329.8	354.6	383.8	413.8	433.2	376.1	183.7
M2	145.2	174.5	222.6	288.6	355.6	577.4	615.4
No. of Listed and Nondefault Issuers	16	24	37	38	49	41	36
No. of Listed Companies	172	217	238	253	282	288	275
SBI 1-month (%)	8.83	12.44	13.99	12.80	20.00	38.44	18.84
SBI 3-months (%)	9.30	12.70	14.25	14.13	12.25	39.00	23.33

Source: Bank Indonesia, and BAPEPAM.

TABLE 2
Stock and Bond Issuers and Size of Issues at par
(Rp trillion)

Period	Stocks		Bonds	
	No. of Issuers	Size (Rp trn)	No. of Issuers	Size (Rp trn)
1988	25	0.17	9	0.93
1989	67	2.26	22	1.56
1990	132	8.01	23	2.09
1991	145	8.98	24	2.22
1992	162	11.16	34	3.86
1993	181	16.07	43	5.76
1994	231	26.53	46	6.69
1995	248	35.40	50	8.69
1996	267	49.98	55	11.54
1997	306	70.88	70	18.74
1998	309	75.95	70	18.89
1999 (October)	314	202.20	72	21.47

Source: BAPEPAM.

Compared with the massive growth in bank lending, the total rate of growth for outstanding bonds was less impressive. Between 1993 and 1996, bank lending increased from Rp150.3 trillion to Rp292.9 trillion, or an average of 31.6 percent per year, while bonds outstanding only achieved Rp8.9 trillion in 1996 up from Rp4.7 trillion in 1993, or an average growth rate of 29.7 percent per year. At the height of the crisis in 1998, bank lending growth achieved 28.9 percent while total bonds outstanding shrank by 8.5 percent. It seems that most potential issuers considered bonds the last resort as a funding source. Even stock market capitalization exhibited more impressive growth than bonds outstanding. In terms of the number of issuers, corporate issuers in the stock market grew from 181 in 1993 to 267 in 1996 and even to 309 in 1998. The number of issuers in the bond market exhibited no significant increases.

The proportion of bonds issued by government entities in the market was quite substantial in August 1999, at 40.5 percent (Table 3), especially issuances by the state-owned electricity company, Perusahaan Listrik Negara. In the early periods, bond issuers were mainly SOEs with low interest rates. The market has now developed to a stage where private firms compete head-on with SOEs. Nevertheless, for a certain segment of the market, especially state-owned pension funds and insurance, there is still an appetite for SOE issuances. This is rapidly fading out, however, with the introduction of market-based performance reviews.

TABLE 3
Outstanding Bonds of Government Entities, August 1999

Category	Entity	No. of Outstanding Issues	Total Size (Rp bn)	Maturity Period	Percentage of Total
SOEs	BPD DKI	1	500.0	2004	
	BPD Sumbar	2	200.0	2002	
	BTN	5	950.0	2000–2002	
	Jasa Marga	2	70.0	2001	
	Pegadaian	4	264.6	2001–2003	
	PLN	10	3,017.9	2000–2007	
	Wijaya Karya	1	100.0	2003	
	<i>SOEs Subtotal</i>	25	5,102.5		40.5
Other (28 Issuers)		41	7,492.9		59.5
Total		66	12,595.4		100.0

Source: Subaraya Stock Exchange, August 1999.

TABLE 4
Sectoral Breakdown of Outstanding Bonds, 1999

Sector	Percentage
Basic Industry and Chemicals	15.3
Manufacturing Industry	7.0
Consumer	1.5
Property	14.5
Infrastructure, Utilities, and Transport	22.8
Finance	35.0
Trade, Services, and Investment	4.0

Source: BAPEPAM, November 1999.

In terms of liquidity, the Surabaya Stock Exchange (SSX), where bonds are traded (as well as less liquid shares), exhibited about a third of the amount of activity in 1998 as in 1997. Trading dried up because of the very high interest regime that year, especially in the second quarter. In 1999, as interest rates declined, trading picked up significantly.

TABLE 5
Breakdown of Financial Sector Issuers, 1999

Type	Issuers	Size (Rp bn)
Banks	BTN	950.0
	BPD DKI	500.0
	BPD Sumbar	200.0
	BII	194.7
	NISP	150.0
	Tamara	91.1
FinCos	Sinamas	500.0
	Pegadaian	264.6
	Bunas	250.0
	Bakrie Finance	200.0
	BBL Dharmala	100.0

Source: SSX, 1999.

Prices also rose steadily throughout 1999. For example, in January 1999, when SBI rates were above 50 percent, prices of even the most liquid bonds were around 60 percent. Bonds issued by property companies took the biggest plunge, dropping below 40 percent. Even bonds issued by firms in the pulp and paper sector, which was scarcely affected by the crisis, dropped to around 60 percent. Since then, prices have

steadily climbed back. PLN bonds, due to their liquidity, recorded the best prices. For example, in November 1999, the price of PLN VA bonds went back to above par. Pindo Deli's price was trading close to par at around 96 percent.

TABLE 6
Jakarta and Surabaya Stock Exchanges: Trading Volume

Period	Jakarta Stock Exchange		Subaraya Stock Exchange	
	Volume (billion)	Value (Rp trillion)	Volume (billion)	Value (Rp trillion)
1988	0.01	0.03	—	—
1989	0.10	0.96	—	0.03
1990	0.70	7.31	0.01	0.14
1991	1.01	5.78	0.01	0.04
1992	1.71	7.95	0.04	0.14
1993	3.84	19.09	0.27	1.15
1994	5.29	25.48	0.50	1.78
1995	10.65	32.36	1.72	5.25
1996	29.53	75.73	1.55	4.10
1997	76.60	120.39	4.90	10.75
1998	90.62	99.68	2.23	3.12
1999 (October)	147.52	118.42	5.11	11.41

Source: JSX and SSX.

TABLE 7
Comparison of Selected Bond Prices

Sector	Size (Rp billion)	Maturity	January 1999		November 1999	
			Rating	Price	Rating	Price
Property						
Duta Pertiwi III	350	August 2002	BBB-	52.50	BB+	86.63
Manufacturing						
Pindo I	200	January 2002	A-	65.00	A-	95.88
Utilities						
PLN VA	343.75	August 2001	BBB-	66.00	BB	101.25
Banking/Finance						
BTN VIII	400	July 2002	BBB	95.00	D	94.00
Consumer						
Mayora I	300	July 2004	A+	38.00	BBB+	86.50
Infrastructure						
CMNP II	275	March 2002	CC	37.00	B	92.50

Source: SSX, November 1999.

The most severe downturn in credit was recorded in 1998, when 14 bonds defaulted (13 bonds on interest and one, Dharmala, on both interest and principal due in November). The default rate for that year was recorded at around 15 percent, which along with high interest rates and the severe economic downturn significantly reduced investor confidence and appetite for risk, as reflected in the very low prices for many papers. Most defaults occurred in the property sector, with 10 defaulted bonds, and the manufacturing sector, with three bonds that defaulted. In terms of the number of outstanding bonds, however, the manufacturing sector recorded the largest defaults. These exerted a strong downward pressure on the prices of surviving bonds in the two sectors, averaging 20 percent to 30 percent in 1998.

TABLE 8
Indonesian Bond Default Rate

Bond Type	September 1997		Defaults in 1998	
	Number of Bonds		Number of Bonds	Percentage of Total
<i>By Rating:</i>				
A	9			
A-	6			
BBB+	18		3	16.7
BBB	14		4	18.6
BBB-	11		2	18.2
BB	1		1	100.0
Not Rated	35		4	11.4
Total	94		14	
<i>By Sector:</i>				
Banking	39		1	2.6
Property	24		10	41.7
Manufacturing	7		3	42.9
Automotive	3			
Pulp and Paper	3		18	
Infrastructure	18			
Total	94		14	
Default Rate (%)	14.89			

Source: Rowter and Susanto, 1999.

In short, the most critical problem facing the development of a bond market before the crisis was lack of supply. The limited number of issuers, which was dominated by SOEs, restricted investors' ability to spread their risks in the bond market. During the crisis, SBI one-month rates increased significantly to 38.44 percent per year, which hit the bond

market extremely hard. These high rates meant that investors required higher yields as an incentive to purchase. Given the extremely high required yields, no issuers were willing to tap the bond market at the time. Therefore, the most important problem shifted to one of demand stifled by the higher risk involved. At the time of writing, primary concerns within the overall debt market included high sovereign risk, low rates of bank lending, and currency risk. If these conditions continue, the bond market will become the most accessible source of funding, while the number of bank loans issued will remain low. Problems within the bond market will probably change again in the near future to doubts about oversupply, since involvement of foreign investors will be less likely, and domestic investors' ability to absorb the coming issuances may be limited.

A. Corporate Market and Financing Behavior

Corporate bonds account for a major share of all outstanding bond issues, and this seems to be increasing. Most corporate bonds are issued by financial institutions to fund lending operations, and the largest issuer in this sector is Bank BTN. This bank's main line of business is providing housing loans. The second-largest issuer is shared by BPD DKI (the regional development bank of the Jakarta special administrative region) and a finance company belonging to the Sinarmas group.

The minimum denomination for corporate bonds ranges from Rp100,000 to Rp100 million. Only limited liability companies registered in Indonesia are authorized to issue bonds. Indonesian investors generally perceive large, exchange-listed corporations to be more credit-worthy than private companies. Therefore, the only issuers of corporate debt in Indonesia are the large, exchange-listed corporations.

Corporate bond issues for 1999 are expected to total Rp2.2 trillion (about US\$275 million). Most of these corporate issues are floating rate bonds, and priced at a spread over the Jakarta Inter-bank Offered Rate (JIBOR).

The shallowness of the corporate market can be attributed mainly to the lack of a long-term interest rate benchmark and market fragmentation.

On the supply side, there have only been a few companies with a good credit stance that have issued in the domestic market. This is mainly because in the past they had easy access to the international capital market, and issuing bonds offshore was cheaper.

In addition, the issue of corporate governance has been a problem. This must be addressed, and minimum standards adopted, if the corporate bond market is to develop.

The market has also suffered from weak disclosure rules and uneven market information flow, making credit risk assessment difficult. In

addition, the legal framework needs a lot of improvement, such as protection and transfer of property rights, legal recourse for bond investors (especially bankruptcy procedures), procedures for resolving commercial disputes and contract enforcement. The market infrastructure is also weak, especially in terms of clearing and settlement, and a cumbersome tax procedure makes the trading process awkward.

1. Offshore Financing and Foreign Participation

Besides domestic issuance, Indonesian firms also tap the international market (Table 9). The appeal of offshore funding is the lower cost (in particular before the economic crisis, where the rupiah was practically in a crawling peg, depreciating on average 4–5 percent per annum). The largest issuer was the Sinarmas Group, which is among the world's largest pulp and paper manufacturers. Its outstanding bonds alone amounted to about US\$4.5 billion, around 60 percent of the outstanding bonds issued by Indonesian entities. The sovereign issues were made in 1996 mainly to test the international appetite for Indonesian sovereign instruments, and to provide some kind of benchmark for offshore borrowing. Following the crisis, the offshore appetite for Indonesian issues dried up. In particular, investors are paying attention to PLN's recent plan to renegotiate its contracts with several independent power producers (IPPs). PLN has threatened to cancel the contracts unilaterally, arguing that it signed them under duress.

TABLE 9
Indonesian Outstanding Offshore Bonds, 1998
(US\$ million)

Issuer	Type	Size	Issuer	Type	Size
<i>Republic of Indonesia</i>		700	<i>Polysindo Group</i>		510
RI 06	FX	400	Polysindo International 06	FX	260
RI 01	FRN	300	Polysindo International 07	FX	250
Sinarmas Group	FRN	4489	<i>Dharmala Intitutama 99</i>	FRN	200
APP Global-Cayman 02	FX	638			
Indah Kiat-Mauritius 07	FRX	600	<i>Sampoerna</i>		
APP Global 01	FX	600	Sampoerna International 06	FX	200
Tjiwi-Mauritius 04	FX	600			
APP International 05	FX	450	<i>Astra</i>		
Pindo-Mauritius 07	FX	450	Astra Overseas 03	FX	200
Indah-Kiat International 00	FX	351			
RAPP-International 05	FRN	200	<i>PT BDN-Cayman 05</i>	FRN	180
APP International 99	FX	200			
Tjiwi-International 02	FX	200	<i>Others</i>	Various	700
Indah-Kiat International 02	FX	200			
Pratama Datakom Asia 05		260	Total		7439

Source: *Asiamoney*, June 1998.

Foreign participation in the capital market (Table 10) peaked in 1994. Since then, local participation has steadily increased. The rapid decline in foreign participation in 1997, continuing up to 1999, was due to the sharp fall in confidence and the massive pullout of foreign investors. Although foreign participation is still substantial in the stock market, in the bond market it is domestic institutions that will probably continue to be the main driving force for the immediate future.

TABLE 10
Share of Domestic and Foreign Capital
(percent)

Year	Domestic	Foreign
1992	40.92	59.08
1993	39.50	60.50
1994	29.83	70.17
1995	39.66	60.34
1996	47.82	52.18
1997	58.31	41.69
1998	61.91	38.09
1999	61.91	38.09
January	47.42	52.58
February	53.51	46.49
March	48.74	51.26
April	51.94	48.06
May	55.30	44.70
June	64.00	36.00
July	60.26	39.74
August	62.20	37.80
September	62.71	37.29
October	78.76	21.24

Source: BAPEPAM.

2. Impact of Bank Recapitalization on the Bond Market

As part of the process of postcrisis restructuring of the financial sector, especially the banking sector, which is vital to any attempt at recovery, the Government established the Indonesian Bank Restructuring Agency (IBRA). It realizes any proceeds from assets taken over, and therefore minimizes the restructuring cost. Besides closing several banks and taking over the operations of others, one of its main tasks in restructuring is to recapitalize banks whose equity has deteriorated sharply due to negative interest margins and the requirement that banks set aside enough funds—usually taken from equity—to cover loan losses, especially those that are group related.

The Government decided to issue bonds directly to banks rather than injecting the cash proceeds, due to the market's limited ability at the time to absorb the huge volumes made necessary by the recapitalization program. It was envisaged that recapitalization on a piecemeal basis would not be appropriate because of the lack of a local market for government bonds and the high costs associated with issuing them overseas. The Government also needed to issue bonds to replace the cash liquidity support that the Central Bank had been handing out following the runs that started in November 1997, when the Government closed 16 private banks. This, plus the political uncertainty and the fluctuating rupiah, eventually resulted in a run on Bank Central Asia (BCA), the largest private bank in the country.

However, several factors contributed to long delays in the decision to actually issue the bonds. First was the initial failure to realize that the crisis would be so profound and the recapitalization costs so high. Second was the effect of political disturbances culminating in the resignation of President Suharto and the hand-over of the government to B.J. Habibie. Third was a change in the IBRA leadership. Therefore, although the plan had been formulated by the third quarter of 1998, it went into effect only in April 1999. The first type of government bond issued was that used to finance the Government's obligations to the Central Bank.

B. Types of Securities

State-Related Agencies (SRAs) issue debt at the instruction of the Minister of Finance, and are exempt from some regulations that apply to private sector issuers. The minimum denomination for these bonds ranges from Rp1 million to Rp100 million, with the majority having a five-year maturity.

Sertifikat Bank Indonesia—Certificates of Bank Indonesia (SBIs). SBIs were introduced in February 1984. Their assigned use was for monetary contraction. Originally, SBIs were issued weekly through several banks assigned as market makers, with 30- and 90-day maturities. The denominations were originally set at Rp50 million, Rp100 million, and Rp1 billion. Since 1986, BI has also conducted daily SBI auctions, and when necessary, BI also issues bilateral SBIs with certain banks. In a further development, BI auctioned SBIs with maturities of 6 and 12 months starting in 1988. In the early 1990s, there was substantial foreign participation in the SBI market due to its attractive interest differential with US Treasury notes. Nevertheless, secondary market trading in SBIs remains subdued because banks prefer to keep SBIs as secondary reserves. Tables 11 and 12 summarize SBI volume and rates from 1994 onwards.

TABLE 11
SBI and SBPU Volume
 (Rp billion)

Year	Interbank Call Money	SBI			SBPU		
		Issuance	Repayment	Outstanding	Purchase	Redemption	Outstanding
1994	110,990	92,117	100,499	15,052	67,621	65,175	3,842
1995	189,259	98,706	101,908	11,850	140,172	139,809	4,205
1996	477,563	157,948	151,245	18,553	121,524	125,558	171
1997	784,367	176,450	187,969	7,034	179,956	176,671	3,455
1998	2,104,925	735,913	700,182	42,765	325,516	327,953	1,018
Sep 98	242,381	48,701	53,785	48,726	337	1,390	226
Oct 98	163,500	53,530	62,224	40,031	1,170	232	1,164
Nov 98	181,010	39,299	38,604	40,726	143	146	1,162
Dec 98	108,023	49,428	47,389	42,765	29	172	1,018
Jan 99	58,862	35,896	37,438	41,223	0	0	1,018
Feb 99	60,189	44,599	36,314	49,508	0	0	1,018
Mar 99	53,994	47,946	48,540	48,914	1,018	1,018	1,018
Apr 99	61,617	72,971	59,846	62,039	0	0	1,018
May 99	51,468	55,407	58,086	59,360	0	0	1,018
Jun 99	47,385	54,548	50,030	63,879	0	0	1,018
Jul 99	51,725	75,636	65,949	73,566	0	0	1,018
Aug 99	38,829	56,194	59,218	70,542	0	0	1,018
Sep 99	37,352	73,148	71,102	72,587	0	0	1,018

Source: Bank Indonesia.

TABLE 12
SBI and SBPU Rates
 (% per annum)

Year	O/N	All tenors	7 days	14 days	28 days	91 days	182 days	7 d days	14 days	91 days
1994	9.74	9.87	7.65– 11.48	7.94– 11.08	8.21– 12.44	9.30– 12.70	9.59– 13.00	11.00– 14.50	12.00– 15.25	12.00– 13.14
1995	13.56	13.62	11.81– 13.531	12.27– 14.00	13.05– 14.74	13.75– 14.75	13.50– 14.50	14.89– 15.75	15.25– 15.25	—
1996	14.06	14.13	1.76– 29–	12.00– 8.50–	12.80– 10.50–	13.75– 11.25–	14.00– 11.63–	15.30– 14.75–	—	—
1997	33.63	30.52	18.35	20.06	22.00	13.25	13.50	15.25	—	—
Sep 98	66.21	66.34	—	—	68.76	—	—	—	—	—
Oct 98	59.35	59.60	—	—	59.72	61.51.6	—	—	—	—
Nov 98	65.49	64.99	—	—	51.25	39	—	—	—	—
Dec 98	33.44	39.45	—	—	38.44	36.75	—	—	—	—
Jan 99	37.92	37.70	—	—	36.43	37.5	—	—	—	—
Feb 99	39.97	39.42	—	—	37.50	38	—	—	—	—
Mar 99	41.98	41.79	—	—	37.84	36	—	—	—	—
Apr 99	35.54	35.48	—	—	35.19	30.5	—	—	—	—
May 99	28.76	29.02	—	—	28.73	23.75	—	—	—	—
Jun 99	22.55	22.91	—	—	22.05	16	—	—	—	—
Jul 99	14.84	14.93	—	—	15.01	13.25	—	—	—	—
Aug 99	12.45	12.39	—	—	13.20	13.25	—	—	—	—
Sep 99	12.34	12.46	—	—	13.02	—	—	—	—	—

Source: Bank Indonesia.

Since the crisis, the volume of SBIs outstanding has steadily increased. The biggest jumps occurred in March and April 1998 due to the run on banks, pushing BI to increase liquidity absorption tremendously. A few months later liquidity had eased, but other large increases occurred in 1999. The chief concern in that year was the need to alleviate a negative interest margin. Banks have practically stopped lending since the onset of the crisis in mid-1997. Faced with huge amounts of nonperforming loans during a period of high interest rates; however, most suffered from negative interest margins. This ate away at the capital bases of many banks, which were decimated by the requirement to write off their bad loans.

Surat Berharga Pasar Uang (SBPUs). SBPU was introduced in February 1985 and is used for monetary expansion. There are two forms of SBPU: a promissory note issued by bank customers in connection with their bank loans, and a trade bill drawn by nonbank customers but endorsed by a bank. Banks, in connection with interbank borrowing, can also issue the promissory notes. Maturities range from 7 to 91 days, and the minimum denomination is Rp50 million. The Central Bank decides on the discount rates of SBPUs. Market participants sometimes use this rate as a benchmark. The only entities allowed to sell SBPUs to BI are banks. On the other hand, BI is not bound to buy any set amount, but bases its decision on daily liquidity positions.

The low balance of SBPUs indicates that banks only borrow funds from BI for short periods (usually two weeks) because the interest rates of SBPUs have been higher than the interbank rates.

Other Money Market Instruments. are certificates of deposit, promissory notes, commercial papers, and medium-term notes.

Bank Recapitalization Bonds. Government bonds were issued as part of the bank recapitalization program, as a means of achieving noncash equity injection. Banks to be re-capped include taken-over banks, recapitalized private banks, Bank Mandiri, other state banks (BTN, BNI and BRI), and regional development banks (BPDs). Besides being used for recapitalization, bonds were needed to refinance shareholder debt settlements, as well as the obligations of liquidated banks (Bank Dalam Liknidasi [BDL], Bank Beku Operasi [BBO], and Bank Beku Kegiatan Usaha [BBKU]) to depositors.

From the standpoint of the government budget, bonds are issued to minimize interest payments and to cover any need for cash outlays. Meanwhile, for banks, these bonds are meant to ensure adequate income

to alleviate the adverse impact of negative interest margins on capital, and to give them enough cash flow and liquidity to be able to meet their short-term obligations. Lastly, from the market point of view, they are marketable, without any limitations on ownership.

Based on these considerations, the Government decided to issue three types of bonds. The first was the floating-rate series, with coupon rate equal to that of three-month SBIs. Second was the fixed-rate series, with 12 percent coupon for the five-year series and 14 percent for the 10-year series. Lastly, to cover its obligations to the Central Bank, the Government issued inflation-indexed bonds for which the coupon rate remained at 3 percent, but the principal was indexed to the annual inflation rate. The floating-rate bonds were designed to raise the capital adequacy ratio (CAR) of recapitalized banks to 0 percent. The fixed-rate bonds raised their respective CARs to 4 percent (the temporary target). The final target was stipulated as 8 percent by 2002.

At the time of issuance in 1999, bank deposit rates were extremely high, and provided an inverted yield. The one-month deposit rate had achieved 67 percent per year at its peak. Thus, the Government faced two alternatives: delay the bank recap program until the interest rate declined, or somehow keep it on track without jeopardizing the national budget. The Government chose the second alternative—the bonds' yield shows a dichotomy with outstanding yankee bonds and also corporate bonds. Some outstanding corporate bonds—such as those of HM Sampoerna (HMSP), Astra Sedaya Finance (ASDF), and Astra Agro Lestari (AALI)—offer more attractive yields (around 17 percent) with tolerable risk (AA and A rating), whereas five-year government bond coupons offer only 12 percent. The SBI one-month rate achieved 13.55 percent, and the three-month rate was 13.29 percent as of 23 August 2000. These rates are more attractive than the rate for five-year government bonds, selling at par.

By ministerial decree, the bonds were issued in April and December 1999. The first issuance was meant for the recapitalization of four taken-over banks (BCA, Danamon, Private Development finance Corporation Institution [PDFCI], and Tiara) and seven recapitalized banks (Arta Media, Bank Internasional Indonesia [BII], Bukopin, Lippo, Patriot, Prima Express, and Universal). Originally the list also included Bank Bali and Bank Niaga, but these two banks were subsequently taken over, as the original shareholder could not raise enough funds within the specified time frame.

As of November 1999, the Government had issued bonds amounting to Rp425 trillion. Of this amount, Rp218 trillion was in inflation-indexed bonds placed at the Central Bank and Rp207 trillion in variable or fixed-rate bonds placed at commercial banks. Most of the

bonds issued to commercial banks were for the recapitalization of Bank Mandiri (Rp103 trillion in total, comprising Rp99 trillion in floating-rate bonds and Rp4.3 trillion in fixed-rate bonds). The rest went to the seven recapped banks (Rp22 trillion in total), the four taken-over banks (Rp80.5 trillion), and regional development banks (Rp1.2 trillion). The floating-rate series' coupons were the same as the three-month SBI rate. The fixed-rate bonds were broken down into a five-year bond (amounting to Rp2.2 trillion) with coupon rate of 12 percent and a 10-year bond (amounting to Rp6.5 trillion) with coupon rate of 14 percent.

TABLE 13
Recapitalization Bonds Issued as of November 1999
 (Rp trillion)

	Variable Rate	Fixed Rate	Inflation Indexed	Total
Bank Indonesia	0.0	0.0	218.3	218.3
Commercial Banks	193.8	13.0	0.0	206.8
Private Banks	18.9	3.2	0.0	22.1
Taken-Over Banks	75.4	5.1	0.0	80.5
Regional Development Banks	0.8	0.4	0.0	1.2
Bank Mandiri	98.7	4.3	0.0	103.0
Total	193.8	13.0	218.3	425.1

Source: Ministry of Finance.

The total amount of bonds issued for the purpose of bank recapitalization is estimated to be around Rp620 trillion (or about 62 percent of 1998 GDP). Additional amounts on top of the Rp425 trillion already issued will go first to the seven private banks already recapitalized, estimated to amount to about Rp4 trillion. Next, an additional eight taken-over banks will require about Rp30 trillion in recapitalization. Bank Mandiri alone has requested an additional Rp60 trillion. Lastly, the other state banks (BRI, BNI, and BTN) will require about Rp100 trillion in total. This brings the additional amount of bonds required to about Rp194 trillion.

Of the bonds issued, the majority (92 percent) were in the form of floating-rate bonds, leaving a relatively tiny amount in fixed-rate bonds. This was because of the huge burden the floating-rate series had to bear in raising banks' CARs to zero. Secondly, the maturity profile was such that the refinancing burden was spread out with a bias toward later periods, thereby alleviating the budgetary burden in the short term. Another

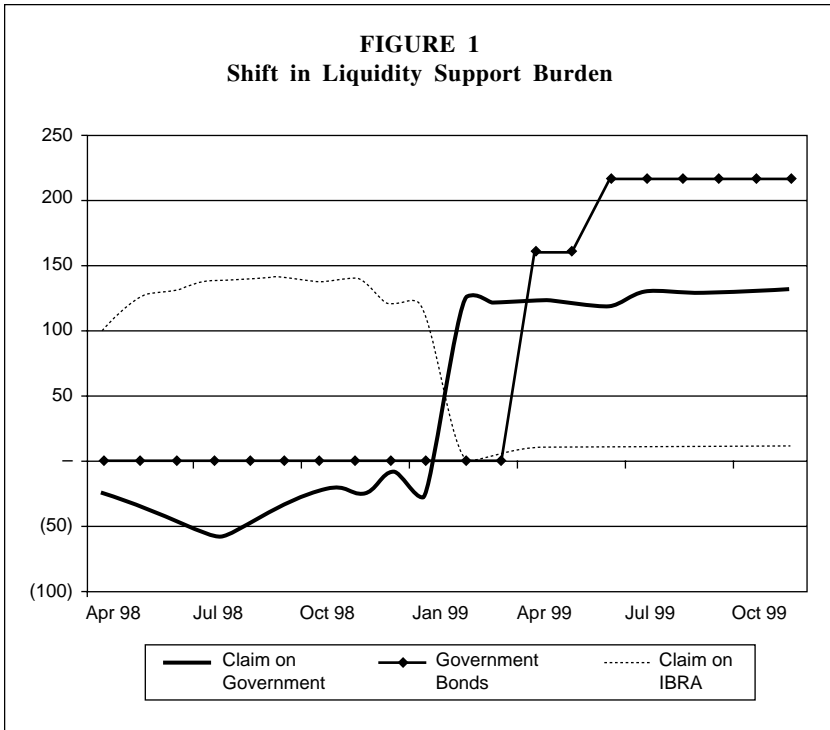
feature was that the coupon payment for the floating-rate series was quarterly, to enable cash-strapped banks to begin earning interest as soon as possible.

Because the process of issuing government bonds was quite protracted, and because the banks needed cash infusions well before the bonds could be distributed, it was agreed that the book entry procedure would be as follows. First, the Central Bank would charge its cash infusions (called liquidity support) to the banks themselves. Next, the expenditure would be charged to the IBRA, an amount that by February 1999 had grown to over Rp113 trillion. Before the government bonds were issued, at the end of February 1999, IBRA's burden was handed over to become part of the Central Bank's claim on the central government.

In terms of bank recapitalization, the Government has in its possession bad loans transferred from banks to the asset management unit (AMU) under IBRA. Also included are assets from banks' shareholders as part of their group loan settlement and the Government's equity in recapitalized and taken-over banks. On the liability side is the Government's obligation from the issuance of bonds. Meanwhile, income is expected to be derived from sales of shareholder assets, loans and other settlements, sales of government equity in banks, and any interest income from loans that remain on the books of the AMU.

Shareholder settlements and settlement from debtors on loans in the books of the AMU will depend on negotiations, which have started. The AMU distinguishes debtors by their ability to repay and their good will in doing so. Nevertheless, the overriding principle is to prioritize cash and asset settlement over restructuring and cuts. To expedite recovery, IBRA has initiated sales of liquid assets, especially noncore assets such as paintings, furniture, and other office fixtures.

The Government also expects that within two to three years after economic recovery, the local bond market will have recovered, and secondary market liquidity will be sufficient to enable a funding exercise to finance maturing bonds. Should the bond market not be ready for this, another option is for the Government to refinance maturing bonds with a further issuance. Yet another option is for the Government to go abroad for its funding needs. At the moment this approach is costly given Indonesia's CCC+ rating, but with improvements in the political sphere as well as the economy, the rating could change. Borrowing costs—should Indonesia regain its investment-grade rating—could be relatively lower than the costs of issuing bonds in the domestic market. The government is also considering some form of natural resource securitization to lower borrowing costs.



Trading to Date. The Central Bank has allowed recapitalized banks to place a total of Rp2.2 trillion in their securities trading accounts. The rest, i.e., the bulk of the total issuance, is placed in the banks' investment accounts. Only those bonds in the trading account may be traded. The Central Bank has said that it will review the securities trading ceiling and may increase it if necessary. The main reason for allowing only minute amounts to be traded has to do with the perception that at least at first, the market will absorb only small portions. From the point of view of prudence, this practice allows banks some breathing room, given that holdings in trading accounts need to be marked to market regularly (in this case, every month, as part of the Central Bank's review of bank statements). The Central Bank is also being prudent from a macroeconomic point of view, because if banks with enough capital but insufficient liquidity were to start selling their government bonds at a deep discount, the result would be a rise in interest rates.

At the same time, the yields on those government bonds that can be traded remain close to the prevailing short-term deposit rates and substantially below the returns on corporate bonds. On the supply side,

banks are currently having difficulties in expanding credit. In addition, given that their capital adequacy ratios are very near the specified 4 percent, the banks cannot be expected to sell their government bonds at a discount. This price gap has meant that only one trade has taken place so far, with a volume of Rp5 billion.

Foreign investors are not interested at present either, for several reasons. One is the continuing political uncertainty. A second is the exchange rate volatility, accompanied by very thin hedge markets, which both result in a scarce supply of forwards or swaps. The third is the yield. At the current spread of the Indonesian yankee (RI-06) of around 500 basis points plus the five-year US Treasury rate, the expected yield becomes around 11–12 percent in US dollars. Converted through the forex swap rate of around 3–4 percent, the expected yield in rupiah becomes 15–16 percent, which is much higher than that promised by government bonds currently available for trading.

TABLE 14
Recapitalization Bonds Available for Trading

Series	Amount (Rp bn)	Latest Coupon (percent)	Coupon Payment	Maturity
FR0001	0.32	12.00	Semiannually	15 Sep 04
VR0001	1.31	11.41	Quarterly	25 Jul 02
VR0002	0.19	13.05	Quarterly	25 Feb 03
VR0005	0.35	13.05	Quarterly	25 May 04
Total	2.17			

There are other possible reasons for the thin trading. One is the lack of documentation, such as a prospectus. Another is the lack of a trading system. Although the Central Bank has issued regulations regarding trading and settlement, market makers are yet to be appointed. One reason for the delay is the fact that no mechanism is in place to ensure short covering. The Central Bank is barred by the new Central Bank Law from lending to the Government, and its current monetary tightening stance does not allow purchases from the secondary market. Therefore, the Central Bank has asked the Ministry of Finance (MOF) to act as a buffer if a market short position is to occur, and also if the reverse were to take place. It is expected that once the Debt Management Unit (DMU) becomes operational, this can be settled.

Risks. Trading of government bonds under present circumstances carries certain risks. One, as mentioned before, is that if the recapitalized banks

were to offload their bond holdings at a discount, their CARs would deteriorate. Yet as long as the Government is the majority shareholder in the recapitalized banks, the only situation in which these could cover losses from selling bonds at a discount would be if the Government were to inject more capital. Given the government's lack of funds, this is unlikely. Discounted sales will probably have to wait until these banks can raise capital from the stock market, assuming the proceeds are not used exclusively to repurchase government shares. Another method would be to wait to sell bonds at a discount until these banks can earn enough income from their other lending activities. However, even through the end of 2000, massive lending by the banking sector is not expected to happen.

Another risk is with the refinancing of the recapitalization bonds. The first series (variable rate 001) will mature in 2002. The burden of principal payment will rise continuously until it peaks in 2009 for variable and fixed-rate bonds. Between 2009 and 2017, no bonds will mature. But in 2017 and 2018, the large volumes of indexed bonds will mature. Currently it is not known whether the Government has any refinancing plans. Most countries start considering refinancing plans as soon as they issue bonds, and any refinancing plan that relies on the market absorbing further bond issuances must entail the creation of a liquid government market.

C. Investor Base

The biggest investors in domestic Indonesian bonds today are large domestic insurance companies, pension funds, domestic banks, and securities firms, such as Taspen (the country's major pension fund for state employees) and Astek (the state-run pension fund for the participating private firms). There are also a number of fixed income mutual funds. Participation by domestic banks in the bond market is still fairly new. Nonetheless, increased trading by them has led to a deepening of the secondary market.

In the early periods, the major SBI investors were SOEs, state banks, and private banks, with foreign banks playing a minority role (Table 15). The involvement of SOEs has steadily declined, as they have largely moved into bonds, leaving banks as the most important players. It is noteworthy that most of the outstanding SBIs at the beginning of 1998 were held by foreign banks. The main reason was that during this period these banks received a lot of new deposits from customers wary of keeping their savings in domestic banks. Hard pressed to put their inventory to use, given that nearly all other lending channels were closed due to

the very severe credit risk, the foreign banks found SBIs as the only safe avenue left. On the other hand, several banks experienced runs, requiring them to cash in their SBI holdings.

TABLE 15
Central Bank Securities (SBI) Ownership Structure

Year	Percentage to Domestic SBI Holding					SOEs	Domestic/ Total	Foreign/ Total	Out- standing (Rp billion)
	State Banks	Private Banks	Regional Banks	Foreign Banks	Non- Banks				
1995	18.0	22.2	2.0	2.4	0.5	54.9	100	—	11,851
1996	16.9	43.9	0.3	4.1	0.1	34.7	100	—	18,577
1997	13.2	26.5	0.3	18.3	0.2	41.6	65.7	34.3	12,625
Jan 1998	5.4	7.1	0.3	82.8	0.2	4.1	67.4	32.6	13,919
Feb 1998	7.0	5.3	0.2	87.4	0.2	—	63.7	36.3	13,845
Mar 1998	6.6	17.6	0.2	75.0	0.6	—	62.6	37.4	24,049
Apr 1998	9.1	21.1	0.4	66.6	2.8	—	47.9	52.1	27,484
May 1998	18.5	33.1	0.1	46.3	2.0	—	82.5	17.5	55,441
Jun 1998	23.9	25.2	0.1	44.1	6.7	—	79	21.0	56,087
Jul 1998	23.0	11.4	1.2	53.7	10.7	—	72.8	27.2	40,277
Aug 1998	13.3	37.6	1.4	35.0	12.7	—	84.2	15.8	62,652
Sep 1998	12.1	47.1	1.9	28.4	10.6	—	81.7	18.3	57,268
Oct 1998	14.9	48.4	0.3	31.2	5.3	—	82	18.0	48,567
Nov 1998	20.5	42.2	0.3	31.6	5.4	—	84.1	15.9	48,283
Dec 1998	21.4	45.3	0.1	31.7	1.5	—	85.8	14.2	49,715
Average 1998	14.6	28.5	0.5	51.2	4.9	0.3	74.5	25.5	

Source: Bank Indonesia.

IV. Bond Market Infrastructure

A. Primary Dealer System

There are currently 21 market makers for SBI, through which the Central Bank conducts its auctions. Primary dealers are required to announce quotations and to participate in every auction, and can trade SBIs and SBPU's outright under a repurchase (repo) arrangement. Market makers are also expected to actively trade SBIs in the secondary market. The market makers are routinely scrutinized, based on factors such as frequency of bids, frequency of winning bids, and activities in the secondary market. Market participants have access to an electronic system called PIPU (Money Market Information Center), which provides information on rates, overall transaction volumes, and volumes for individual banks.

The major PDs are

- PT Bahana Securities
- PT Bank Negara Indonesia
- PT Bank Niaga
- PT Bank NISP

- PT BNI Securities
- Citibank NA
- PT Danareksa Sekuritas
- HSBC Markets
- PT Indoinvest Securities
- PT ING Baring Securities Indonesia
- PT Jardine Fleming Securities
- PT Schroders Indonesia
- PT Sigma Batara
- PT Trimegah Securities
- PT UBS Securities Indonesia

B. Issuance Methods and Procedures

The institutions involved in the issuance of bonds other than BAPEPAM (Badan Pengawas Pasar Modal, a capital market supervisory agency) are the lead underwriters, rating agencies, public accountants, notaries, trustees, legal advisors, and printers, all of whom must be registered with BAPEPAM.

The lead underwriter coordinates the whole issuance process. For smaller issuances, it is common for the underwriter to take on the entire amount. For larger sizes, the lead underwriter is tasked with setting up an underwriting syndicate. Usually, the lead underwriter handles the primary marketing effort. Depending on the issuance size and other market factors, the lead underwriter's fee structure can be based on either a best-effort or a full-commitment scheme. In a best-effort scheme, the underwriter (or the syndicate) tries to sell the whole issuance, but any unsold portion is handed back to the issuer. In a full-commitment scheme, the underwriter (or the syndicate) takes the risk of buying any unsold portion. Naturally the fee structure for a best-effort scheme is lower than that for a full-commitment scheme.

The public accountant performs an audit and prepares the issuer's financial statements. It also undertakes to prepare the management outlook and summarizes the firm's financial reports. Furthermore, it prepares a "comfort" letter stating that the firm's accounts are in line with generally accepted accounting practices. Meanwhile, a notary examines the legality of all transactions. Once it is certain that all proceedings are in accordance with the law and regulations, the notary then issues an "act of notary."

The legal advisor is responsible for ascertaining the legal status of the issuer, and performs a legal audit to ensure that all assets, liabilities, earnings, and other matters pertinent to the bond issuance are in line

with the law and other regulations. The legal advisor then issues a legal opinion regarding the issuer. The main task here is to ascertain that all of the assets, including any claims the issuer might have, actually fall within its legal entitlement.

The trustee represents investors and acts on their behalf. In practice, this means periodically ascertaining that the issuer is performing within the boundaries set out in the bond's covenants. For example, if it is stipulated in the covenant that the issuer's debt-to-equity ratio should not rise above a certain measure, and this has been violated, it is the trustee's obligation to inform the issuer and investors of this fact. It then has to issue warnings to the issuer or conduct other actions as laid out in the covenant. Typically, coupon and principal payments are channeled through the trustee.

SBI Auction System. Until July 1998, the SBI auction system consisted of the Central Bank setting rates and letting the market bid the appropriate rate levels. This was done because, until that time, rate setting was of paramount importance to the Central Bank. Afterwards, the mechanism was changed to a reverse auction, whereby the Central Bank indicates one day beforehand the amount of SBIs it would like the market to purchase. Following this announcement, rate submissions are accepted and the Central Bank then decides the SBI volume it would like to release. Typically the auction caters to 80–90 percent of the total submissions. SBI auctions are now conducted weekly for one-month maturity certificates and monthly for three-month maturity certificates. Settlement is T+1. Transactions are carried out electronically using a book-entry system in which the Central Bank acts as the custodian, negating the need for physical delivery. BI maintains an electronic registry to monitor ownership changes and the secondary transactions of SBIs.

Bank Recapitalization Bonds. The issuance process for bank recapitalization bonds involves three parties: the MOF, the Central Bank, and the recapitalized banks. First, the MOF issues bonds placed at the Central Bank, for which the Central Bank credits the Government's account. Next, the MOF injects equity into recapitalized banks. The banks issue the appropriate number of shares, handing them over to the MOF. The banks use the proceeds of the share injection to purchase government bonds from the Central Bank, which simply credits the banks' accounts in its own books. As these steps take place simultaneously, there is no need for cash transactions. Furthermore, it is mandatory that the proceeds from the Government's equity injections be used to purchase the appropriate amounts of government bonds.

TABLE 16
Evolution of Indonesian Capital Market Institutions, 1996–1999

Types of Institutions	1996	1997	1998	Sep 1999
Securities Companies				
Brokers/Dealers	111	211	205	201
Underwriters	100	116	112	110
Investment Managers	62	60	61	65
Securities Company Representatives				
Brokers/Dealers	792	1,188	1,595	1,805
Underwriters	489	781	937	990
Investment Managers	249	449	571	677
Investment Funds Selling Agents	—	158	177	253
Custodians	25	29	27	23
Securities Administrations	13	13	12	11
Depository Agency	—	—	—	1
Clearing Guarantee Agency	—	—	—	1
Trust Agents	13	16	16	16
Appraisal Firms	47	53	61	66
Law Partners	102	173	232	251
Civil Law Notaries	41	102	119	159
Accounting Partners	208	226	236	239
Credit Rating Agencies	—	—	1	2
Investment Advisory Firm	—	—	—	1

C. Secondary Trading Systems

Indonesia has two stock exchanges: the Jakarta Stock Exchange (JSX) and the Surabaya Stock Exchange (SSX). JSX was formed in 1992 as Indonesia's main stock trading center. As of July 1999, there were 275 companies listed on JSX, with a total market capitalization of Rp424.9 trillion. There were 197 members, including both local and joint venture brokerage firms. The JSX trading system, known as JATS, has been in operation since 1995. SSX was formed in 1989, and is the country's main bond trading center. The exchange has less stringent listing requirements than JSX, and focuses on attracting small- and medium-sized bond issuers. Most of Indonesia's domestic bonds are listed on the SSX. As of July 1999, it had 116 broker members. The exchange's trading system, known as SSX trading system, or S-MART, has been in operation since 1996.

However, most secondary transactions are carried out over the counter (OTC) among dealers. Not all transactions are reported or officially recorded, and this mechanism has been largely left to the players due to a lack of clear rules. Since the launch of the OTC fixed-income service

(OTC-FIS) by the SSX, a growing number of transactions has been reported, and several participants regularly quote prices. Nevertheless, the system is still in its infancy and most transactions are still not reported. In addition, price quotations are given only for the most actively traded bonds.

Under the current Capital Market Law, it will be very difficult to improve the transparency of the bond market, as it only imposes transparency provisions on exchange transactions. It does not require brokers or dealers to report to any exchanges (either JSX or SSX) or quotation media (Reuters, Bloomberg, etc.) Furthermore, brokers and dealers are able to hide their margin or spread picked up from investors, and there is no standard code of conduct among brokers and dealers, meaning quotations are not very reliable.

At the moment there is no final word on whether the Central Bank or SSX should trade in government bonds. Given the experience of several other countries, the prospects for an exchange-traded bond market, especially for government bonds, are not encouraging. The main reason is the intrinsic differences between stocks and bonds. Whereas two stocks from a single firm are indistinguishable, this is not the case for bonds. In addition, bonds are usually traded in relatively large denominations, and the number of participants is smaller than for stocks. Furthermore, bond investors are usually institutions that, again, deal in relatively large sizes. Given these features it is natural that bond trading gravitates toward OTC systems.

In Indonesia, the sheer amount of potential trades in government bonds would strain any clearing and settlement system. At the moment, Indonesia's system caters to a bond market capitalization that is comparatively tiny. However, the Central Bank SBI trading mechanism recently has been able to handle transaction sizes in excess of Rp10 trillion per week. This is therefore the natural first choice for trading. In the future, when the clearing and settlement system in the exchange has been upgraded to be able to cater to the large trade sizes required, it might be worth examining the issue further.

D. Other Aspects

1. Benchmark Yield Curve

Among the factors inhibiting the development of a deep and liquid bond market is the lack of a long-term interest rate benchmark—e.g., domestic government bonds. This shortcoming has effectively hampered investors' ability to assess the risk of long-term debt instruments. Instead, the Government has a long-standing policy of relying completely

on foreign sources to finance its budget deficits. In the past, this has been matched by the willingness of official creditors, under the auspices of the CGI (and multilateral agencies), to finance Indonesia's development. Another disincentive for the government to issue domestic debt is the memory of the recourse to deficit financing, rampant under the Sukarno regime, which led to triple-digit inflation in the 1960s.

In 1989, market participants began to issue floating-rate bonds using the average time deposit (usually six months' tenor) of several state-owned banks as the benchmark. The average spread was 100 basis points (bps) to 400 bps over the benchmark rate. An additional incentive for using floating-rate bonds was to protect investors from volatile interest rates, especially after the so-called Sumarlin shock.⁶ The main disadvantage of using the average time deposit is that it does not reflect the market interest rate, because state banks' time deposit rates are usually below the average rate for the market (including private banks). Also, the rate differential for small depositors and large institutional depositors is quite large. Institutional depositors generally receive higher-than-published rates.

To overcome these deficiencies, Danareksa (Indonesia's largest investment bank) introduced the use of the rupiah swap rate as a benchmark in 1996. The first issuance to use this method was the fifth PLN bond (PLN V series A–August, fixed rate) followed by PLN V (series A–November, fixed rate) and PLN VI in 1997 (series C, floating IRSOR6+1.4 percent). The spread was between 1 percent and 1.4 percent. Investors responded positively to the issuance, but the swap rate cannot take the place of a risk-free, long-term rupiah interest rate benchmark. The lack of a benchmark for long-term investment has been one of the chief reasons for the short-term outlook of investors (illustrated by the preponderance of time deposits in the short term, of one to three months).

The rupiah swap rate is taken from Reuters, with ticker designations EROT and EXOT. "EROT" represents the interest rate swap. The EROT page provides information on the interest rate swap of floating to fixed rate and fixed to floating rate. "EXOT" represents the currency swap. The page in Reuters is prepared by Prebon Yamane, Singapore, which has organized some banks to contribute daily quotations in rupiah.

6. Sumarlin was the Minister of Finance at the time. He introduced radical measures to halt the feared inflation due to the heating up of the economy in the late 1980s and early 1990s. The main method used was to hike interest rates by draining liquidity from the market. This was accomplished by ordering state-owned enterprises to convert their deposits into SBIs—that is, the equivalent of a massive open market operation on the part of the Central Bank to absorb liquidity.

Because of the over-the-counter (OTC) format, there are no specific rules for preparing the quotations other than agreements among contributors on items such as spread between bid-ask, time of quotation, etc. There are no transactions underlying the quotations. The result of this quotation system is information of best bid and ask of interest rate and currency swap. There are no binding rules for contributors to execute the swap using best bid and ask. However, this could be the best indicator for players to deal in rupiah swap products.

Current government bonds do not create liquidity in the secondary market even when they are issued because they are unattractive from an investor's point of view. Without such a benchmark, pricing for corporate bonds also becomes problematic. Investors have no reference for the time value of money for long-term instruments. In the short term, investors could rely on the SBI rate, although this cannot be a real benchmark, as noted earlier. Most investors expect a benchmark to be (i) available in several maturities, (ii) market-priced (i.e. the price should be decided through a pure auction process, not through policy decisions), and (iii) risk-free. The SBI rate cannot fulfill the first two criteria. The lack of a benchmark is a chicken and egg problem, in that it is unclear whether more liquidity would result in a benchmark, or if the lack of a benchmark results from market illiquidity. The difficulty in finding an appropriate long-term benchmark creates pseudo-barriers to investors for lengthening their investment horizon—although there are other reasons for short investment horizons, such as the unpredictability of the economy. A small economy, such as Indonesia's, usually acts as a price taker. Some economic indicators, such as interest rates and exchange rates, therefore, are very volatile.

2. Credit Rating

A rating agency's role is to perform due diligence on the issuer and issue a rating based on its findings. The issuer can either accept the rating or reject it and ask that it be withheld. Typically the issuer then goes back and restructures itself before asking for a repeat of the rating process, which can take anywhere from three months to two years.

In 1994 the MOF created the Credit Rating Indonesia, Ltd, PEFINDO. Another rating firm, Kasnik Duff & Phelps (KDF), was licensed in 1997, but at the time of writing its activities were not widely known (probably with the exception of the case of Bank BTN, which asked KDF to perform a rating due to its dissatisfaction with PEFINDO's "D" rating). Because of regulations stating that CPs and bonds must be rated, PEFINDO's business has grown tremendously. From a total of 51 bond and other

debt-instrument ratings requested in 1994/95, the number of rating requests grew to over 100 in 1996 and 1997. In 1998, due to the crisis, the number of rating requests dropped significantly. As of October 1999, there were three rating issuances (Pegadaian, NISP, and Indah Kiat), which can be taken to mean that there were at least that many rating requests.

In future, it is recommended that rating fees should no longer be charged to issuers. As investors are the ones who receive the benefits of rating results (in the form of information about the credit quality of the instrument), they should be the ones who pay for the service. This would stimulate more competition among rating agencies. At the time of writing, competition was very weak because of poor rating quality.

TABLE 17
Number of Requests and Completed Ratings
by Credit Rating Indonesia, Ltd.
 (Rp billion)

Type	1994/95		1996		1997		1998	
	Count	Amount	Count	Amount	Count	Amount	Count	Amount
<i>Requested Rating</i>	49	4,916.2	110	8,955.8	98	15,660.0	4	n.a.
Bonds	13	2,384.7	19	4,775.0	40	12,225.0	1	64.5
Commercial Papers	22	2,531.5	50	4,180.8	23	3,435.0	1	n.a.
General Obligations	13	—	31	—	15	—	2	n.a.
Reviews	1	—	10	—	20	—	n.a.	n.a.
Withdrawn	2	150.0	3	550.0	21	5,775.0	n.a.	n.a.
<i>Completed Rating</i>	17	2,237.5	115	8,861.5	117	17,135.0	n.a.	n.a.
Bonds	11	2,084.7	16	3,800.0	43	13,200.0	1	64.5
Commercial Papers	1	152.8	57	5,061.5	33	3,935.0	n.a.	n.a.
General Obligations	5	—	33	—	18	—	n.a.	n.a.
Reviews	—	—	9	—	23	—	n.a.	n.a.

Note: n.a. - not applicable.

Source: PEFINDO.

3. Clearing and Settlement

Whereas in the primary market, payment is received before the instruments are issued, in the secondary market payment and delivery are usually negotiated among the parties involved. In most cases, large transactions are made through the services of a custodian bank or between the parties' custodian banks. The settlement date can be as quick as T+2 due to recent improvements in the bank clearing mechanism instituted by the Central Bank. Although banks can perform same-day check clearing, dealers need the extra day to perform verification. Therefore, most transactions are settled at T+4.

In 1993, several state banks and the two exchanges set up the Indonesian Depository and Clearing Agency (KDEI), a joint clearing and custodial service agency. The agency started its netting services for shares in 1994 and planned to offer similar services for the bond market within two years. KDEI also planned to start a scriptless trading system for shares and bonds in 1997. Following the enactment of the new Capital Market Law in 1995, however, the agency was broken up, with two separate agencies to take over its role.

The two separate agencies are KPEI (the Indonesian Clearing and Guarantee Agency) and KSEI (the Indonesian Central Securities Custody Agency). KPEI is a nonprofit self-regulating organization (SRO) owned by the exchanges. It acquired its license from BAPEPAM in June 1998. KPEI has taken over the role of KDEI in clearing certificates. Because the clearing mechanism to date depends on physical delivery, KPEI guarantees to make up for any payment shortcomings in the netting process. The maximum guarantee provided is capped by the available clearing fund. However, the agency does not guarantee against failure in physical delivery.

In its plans to start scriptless trading, KPEI will introduce a procedure whereby the detailed trading entries for each member will be produced by 1930 hours every trading day. For each member, separate forms will be made available for each market (cash, futures, negotiated, etc.). The clearing process will start with a detailed calculation of each member's debt and credit transactions. For the cash market, the plan is for T+4 settlement. A transaction record with debit and credit entries will be provided in electronic form at 1900 hours on the same trading day and in printed form by 0930 hours the next trading day. Based on its own records and those from KSEI, KPEI will provide an obligations fulfillment record in electronic form by 2300 hours on the same trading day and in printed form by 0930 hours the next trading day.

KPEI provides services in the form of member monitoring, risk monitoring, fund guarantee management, and securities lending. The member monitoring service is provided to ensure that each eligible trading member fulfils the basic requirements, such as a specified minimum capital. Risk monitoring entails supervising member activities during trading hours to ascertain that KPEI risk due to these activities does not exceed the specified maximum. It also entails verifying that the specified collateral is sufficient to cover the agency's risk exposure. Collateral can take the form of cash or noncash, including securities, bank guarantees or letters of credit, time deposits (along with redemption authorizations), and guarantee funds. KPEI supervises and manages the collateral to ensure its adequacy. Securities lending is the service provided by the agency

to facilitate trading (especially margin trading) and to anticipate delivery failures.

KSEI is also a nonprofit SRO jointly owned by 32 securities firms, 14 custodian banks, 5 registrars, the 2 exchanges, and KPEI. The main advantage of having a centralized settlement agency is to minimize the risk of theft, forgeries, and human error. Most of the custodian banks open account(s) with KSEI. Currently KSEI facilitates the settlement of transactions by delivering and receiving physical securities certificates. It also offers this service for share transactions. The agency is planning to move to the book-entry settlement system in the near future (plans to do so were delayed in the past when the sharp depreciation in the rupiah pushed equipment costs sharply upwards). In this scheme, brokerage houses and custodian banks will be able to act on behalf of customers without delivering or receiving the actual securities certificates. Instead, share movements will be conducted as book-entry movements. Besides working on the establishment of the book-entry system itself, KSEI is currently working on an efficient conversion system for all securities, to make them depository-enabled.

Due to limitations in the payment system, KPEI uses Bank Mandiri, Standard Chartered, and ABN Amro Bank as paying banks to settle the payment flow of securities trading. KPEI requires securities companies to be clearing members to settle payments to and from other securities companies. However, brokers or dealers involved in bond trading are somewhat different from those who trade in stocks. In the bond market, banks sometimes act as investors as well as brokers or dealers. From the point of view of the settlement process, banks are better than securities companies since they can settle payments or deliver directly within the banking system (for payment clearing) and KSEI (for securities delivery).

A settlement system for the government bond market would reduce the uneven playing field between banks and nonbanks, as well as increase market liquidity. This would allow players to appoint several parties to act as market makers who would consistently offer quotes on several bonds.

V. Regulatory Structure

Law No. 8 on the Capital Market, passed in 1995, stipulated that overall regulating authority rests with the Minister of Finance. BAPEPAM (Badan Pengawas Pasar Modal, a capital market supervisory agency within the MOF modeled on the Securities and Exchange Commission in the US), develops, regulates, and supervises the market on a daily basis.

Along with the Central Bank, BAPEPAM effectively is the regula-

tor of the financial market. Whereas BAPEPAM has to approve any issuance of stocks and bonds (defined as debt instruments with a life of more than three years), BI regulates the money market and the banking sector. Within the current framework, the issuance of medium-term notes (MTNs) with maturities ranging from one to three years is not regulated, which leads corporations to issue this particular instrument on and offshore. The main advantage is that there is no need for rating and registration. Furthermore, an MTN with a put before one year becomes an effective commercial paper with no requirement for disclosure.

Along with BAPEPAM, there are SROs that are authorized to regulate trading, clearing, and settlement procedures (although some of the regulations have to be approved by BAPEPAM). The SROs consist of the JSX, SSX, KPEI, and KSEI. The stockholders of JSX and SSX are securities houses, which can also become their members. As of July 2000, the JSX had 113 members, while SSX had 118, some of them also being members of JSX through cross-membership. These figures have dropped substantially since 1999 because of a new requirement for a minimum net adjusted working capital of Rp5 billion. The main activities of JSX and SSX (as reflected by their income sources) are stock listing and trading. Therefore, the interest in development of SROs is currently focused mainly on increasing the efficiency of their stock transactions through scriptless trading. As noted, the bond market is not yet well developed, but SSX and KSEI have been working on it. SSX provides trading and information systems, while KSEI will have designed the immobilization process of bonds trading by the end of this year.

VI. Major Policy Issues and Recommendations

The main reason for the lack of a domestic government bond market has been the easy access and availability of cheaper funding from overseas (for the central government), or central government subsidies and two-step loans (for SOEs and regional governments). In addition, bond financing was not thought to be conducive to maintenance of fiscal discipline.

Therefore, until recently there have been only a few issuances by SOEs and regional government banks. Many others have been discouraged by the lengthy and complicated process of bond issuance, and there has also been some reluctance to accept the rules of the market mechanism.

In the case of the corporate bond market, its shallowness can be attributed mainly to the lack of a long-term interest rate benchmark, due to the lack of a deep and liquid government bond market. In addition, the market is fragmented in that only large institutions (pension funds, banks,

insurance firms) play a lead role as well as, more recently, mutual funds.

From the supply side, only a few companies with good credit stance have issued bonds in the domestic market. This is mainly because they traditionally had easy access to the international capital market, and issuing bonds offshore was cheaper.

The market has also suffered from weak disclosure rules and an uneven flow of market information, making credit risk assessment difficult. In addition, the legal framework needs a lot of improvement, such as protection and transfer of property rights, legal recourse for bond investors (especially bankruptcy procedures), procedures for resolving commercial disputes, and contract enforcement. Furthermore, the market infrastructure is weak, especially in terms of clearing and settlement. The cumbersome tax procedure also makes the trading process very inapt.

A. Recommendations

Design New Instruments. Bonds should be designed to meet the needs of institutional investors, as these are the main players. The major institutions are fund management firms, insurance firms, and pension funds, as well as the banking system itself. Until now, the link between the bond market and retail investors has been through fixed-income mutual funds. If the Government also aims at the retail segment, several additional infrastructure issues need to be addressed to create employee participation funds as well as mandatory pension funds for workers in the private sector. The most important recommendation with regard to design would be for the Government to communicate with market participants and—insofar as it is not detrimental to the Government's own financial position—to cater to market appetite. One major trade-off is between catering to investor needs and maintaining enough “substitutability” among instruments to enhance liquidity. The main recommendation would be for the Government to go for substitutability but let the market design other various derivative instruments to cater to investor needs.

For the long-term development of the bond market, besides government bonds, the Government might also consider the housing market as a source of supply. One avenue taken up by other Asian countries has been the creation of a development bank for long-term infrastructure projects, including those initiated by local governments. These banks fund their activities by tapping the bond market. Subsidies, when necessary, can take the form of a lump-sum injection directly into the projects under a competitive scheme, rather than as loans to government entities. This is necessary to ensure credibility and the appropriate channeling of scarce financial resources.

Foreign Funds. In addition to domestic investors, government bond design should also take into account the participation of foreign funds. In this regard it is important to align the design of the bonds with those of other developing countries. Giving foreign participants unlimited access to the local market is a minimum requirement. Equally important, not only for the bond market but also for the capital market as a whole, is a firm stance on free capital inflow and outflow.

Taxation. As more and more countries are dropping taxes on government bonds, it is worth considering the cost-benefit schedule. On one hand, levying taxes on, for example, interest income on government bonds, can generate a sizable income.⁷ But on the other hand, relieving these bonds from their tax burden would increase the yield of the five-year bond from 10.2 percent to 12 percent, a sizable addition of 180 bps. For the 10-year bond the addition would be a hefty 210 bps. Tax relief would also do away with the administrative burden of tax collection. This is especially true in the case of collection of capital gains tax, which at the moment is cumbersome.

Relying instead on a flat transaction tax, just as with stock transactions, would be a much better and more transparent method of generating tax revenues. But this would rely on the bond transactions taking place in the exchange. An alternative would be to levy the tax at a centralized transaction point, such as the Central Bank. Any taxes increase transaction costs, so the Government should carefully weigh the benefits of generating revenues against the benefits of better liquidity.

Stripping the Coupon. Another market friendly move would be to allow market participants to “strip” the bond into the principal and its coupon as separate securities. Naturally the party (or parties) allowed to conduct this operation would need to be part of a select group with the expertise and credibility to do so. Members of the group would include the PDs that deal directly with the Central Bank. Allowing “stripping” can have tremendous benefits for various types of investors with different investment appetites. In addition, the authorities should start looking into government bonds futures trading.

7. Taxes on Rp310 trillion in recap bonds issued to Bank Mandiri and private banks amount to Rp5.6 trillion annually under the current three-month SBI interest rate and tax rate (Rp310 trillion principal x 12 percent interest rate x 15 percent tax rate).

Announced Issuance Schedule. In the primary market, the most important element would be an announced issue calendar. The issue calendar should be spread out in a timely fashion to avoid wide fluctuations in the market. Having an issue plan—preferably an annual one—can be of tremendous help for the investment community in planning its activities. This generally increases liquidity and decreases the issuance cost to the Government.

Issuance Method and Size. Several auction methods exist, and there is a debate surrounding which one minimizes the cost to the Government. There is probably no way to find out which method will accomplish this without trying several. At the start the Government might want to consider a sealed bid, uniform-price auction method.

Another important consideration is the issue size for each tenor. The issuer is well advised to have liquidity stemming from relatively large issuance sizes for key maturities from the short end to the long end in the yield curve. This type of arrangement can assist in creating a “risk-free” benchmark yield curve. Given the current appetite for short-term maturities, the Government would need to exert great efforts to “lengthen” the maturity structure in the financial market. It could consider issuing short-term papers to start tapping the short end of the curve. Many other countries have found that a well-functioning money market is a very important condition for liquidity in the longer-term debt market.

One point that needs careful attention is how to lower the entry cost for market participants in government bond markets. One way would be for the Government to consider reopening the auction window at various periods. The reverse, concentrating on only a few auction windows, usually results in higher costs for PDs, who collectively are usually required to underwrite all or the majority portion of the issue. Reopening the auction window would result in lowering such costs while keeping the issuance objective in sight.

Improve Primary Dealer System. As part of creating a liquid market, it is essential to create a PD system to stand between the Central Bank and the market. The main advantage of having such a system is to alleviate the Central Bank’s burden of dealing with too many institutions at one time. As intermediaries, PDs are expected to act as market makers and to perform the function of traders to other market participants. PDs are naturally expected to collectively subscribe (or underwrite) all or the majority of any bond issuance.

Status as a PD would require a minimum capital base as well as

passage through other screening mechanisms. It is important not to limit membership to commercial banks only, as several investment banks have the essential investor base to make any issue a successful one. Market makers usually have access to repo windows as well as securities lending and borrowing facilities, can act as counter-parties to Central Bank OMO, and can employ other liquidity-enhancing mechanisms. PDs are expected to give quotes on all issues that they are party to and provide market information to the Central Bank.

MOF Authority. MOF should have authority and responsibility for overall policy functions, including debt-management policies such as outstanding amounts, maturity structure, and design of bonds to be issued. A unit should be set up within MOF to handle such tasks, sufficiently staffed by people with the required skills, authority, and contacts in terms of money and debt-market dealings. MOF also should have the authority to issue bonds as it sees fit within the overall government debt framework.

Lengthen Debt Program. Assuming that government bond issues continue to be needed to create liquidity, and the continuing need to establish a risk-free benchmark yield, the Government will need a longer-term debt framework. It is therefore necessary to start considering the feasibility of having a longer-term government budget, at least as a framework and not as a constraining plan. The purpose is to decide quite early on the optimal sizes of the government debt, and then to work these estimates into an issuance schedule. This process also would lend greater credibility to the Government's attempts to fulfil its debt obligations. Having a multiyear budget necessarily impinges on other fiscal policy issues such as the tax system, foreign debt, the growth in routine expenditures, project financing, and, most importantly, the debt repayment schedule for both domestic and foreign obligations.

Central Bank Role in Secondary Market. If the Central Bank is used for trading government bonds, it could play the role of paying agent, automatically debiting the Government's account for payment of interest and principal as necessary. In addition, the Central Bank would be a clearing, custodial, and settlement agent until it becomes feasible for other custodians to participate. In this case, trading would take place between PDs or PDs and other participants. Buyers and sellers would then instruct their respective custodians to debit/credit their cash accounts and do the reverse for the bond positions. For transactions among PDs, the custodians would then inform the Central Bank about these

movements, resulting finally in a change in the PDs' position at the Central Bank. In the case of transactions between PDs and non-PDs, the movement would be between the custodians and the Central Bank. In the first instance, PDs with custody capability would simplify the procedure. The Central Bank would likely play the lead role in secondary market development because it is the entity that deals on a daily basis with market participants and most players (at least at first) would be banks already supervised by it. In addition, market development would likely relate closely to the Central Bank's monetary stabilization role. The Central Bank currently also has the expertise and trading capability to monitor the market.

Government Bonds and Monetary Management. It is also appropriate to start considering the use of government bonds and the government securities repo market as tools for monetary management. To clarify, BI carries a tremendous interest burden in connection with issuing enough SBIs to absorb excess liquidity in the banking system. It is conceivable to start converting portions of the outstanding SBI amount into government bonds. However, two issues would have to be resolved before government papers could be used for this type of monetary management function. The first is the nonexistence of short-term government bills. The second, and more technical, issue is the fact that floating-rate government bonds are benchmarked to three-month SBIs. Addressing these shortcomings would help move the system away from direct intervention into an indirect scheme where signaling would dominate. Reputation would then become the overriding concern of market players, and policy and implementation should be reoriented accordingly.

Policy Harmonization. Another very important issue is the harmonization of fiscal and monetary policies. In this regard, separating the authorities of the Central Bank and MOF has solved one important problem: the potential conflict of interest between the trading and issuing authority. However, a host of other issues need to be addressed in a coherent manner. One of the more important is the inter-relationship between monetary and fiscal policies, especially in the face of the severe economic challenges facing Indonesia. The budgets in coming years are sure to be burdened with the huge cost of bank recapitalization. At the same time, liquidity in the economy is scarce. This creates an upward pressure on interest rates that is detrimental to the budget. If not managed prudently, there is a danger that interest rates and inflation will spiral upward.

Recapitalization Bonds and Secondary Trading. Because the banks that have been recapitalized currently hold the recapitalization bonds (or the so-called IBRA bonds), it falls on BI to regulate issuance in the interest of prudential banking supervision. The main concern is that once the bonds are sold and the proceeds used to increase credit lines, banks that have taken this route will automatically lower their capital adequacy unless more equity is injected at the same time. Banks were allowed to start trading their government bond holdings on 1 February 2000.⁸

Trading in the secondary market for government bonds should start soon. The main benefit would be the injection of liquidity into some of the largest banks in the country. At the same time, other measures to revive the credit market are essential because there is probably substantial excess liquidity in the system at present.⁹ Therefore, any increase in liquidity might not be what is needed at the moment. Nevertheless, the recapitalized banks are the largest in the system, and it is safe to assume that they are the ones with the best fund-distribution channels. Any increase in their liquidity could break the deadlock in the credit market. At the same time, given the minute size of the (corporate) bond market, a sudden increase in supply could result in a glut and have an adverse impact on the market itself.¹⁰

8. Bank Indonesia has stipulated that recapitalized banks must divide their bond holdings into investment and trading accounts. Banks will be allowed to trade up to 10 percent of their total government bond holdings. Before the lifting of the trading ceiling, BI will decide which maturities and sizes may be traded. In addition, banks will be allowed to use the government bonds in their trading accounts as collateral to alleviate liquidity pressures.

9. The October 1999 amount stood at Rp8 trillion. Later data were not available at the time of writing.

10. The capitalization of the bond market stood at Rp15.4 trillion in December 1999. An estimate of the amount permitted to be released into the secondary market is Rp20.7 trillion, or 10 percent of the amount of government bonds already in commercial banks.

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Appendix 1

Recent Government Budgets

TABLE A1.1
1998/99 and 1999/2000 State Budgets
 (Rp billion)

	Revenues			Expenditures	
	1998/99 Actual	1999/2000 Budget		1998/99 Actual	1999/2000 Budget
Domestic Revenues	149,303	140,804	Routine Expenditures	171,205	134,556
Oil and Gas	49,711	20,965	Civil Services	24,781	32,037
Oil	32,909	12,443	Goods Procurement	11,425	11,039
Gas	16,803	8,522	Subsidies to Regions	13,290	18,430
Non Oil and Gas Revenues	99,591	119,839	Interest and Amortization	66,236	44,811
Income Tax	25,846	40,626	Domestic Debt	1,940	380
Value-added Tax (VAT)	28,940	34,697	External Debt	64,296	44,431
Import Duties	5,495	2,950	Principal	33,262	33,262
Excise Tax	7,756	9,360	Interest	31,035	31,035
Export Tax	943	2,595	Other Routine Expenditures	55,473	28,239
Property Tax	3,411	3,247	Fuel Subsidy	27,534	9,986
Other Taxes	540	565	Others	27,939	18,253
Non-tax Revenues	26,660	25,799			
Others	18,145	18,716			
Development Revenues	114,586	77,400	Development Expenditures	92,683	83,648
Program Aid	74,045	47,400	Rupiah Expenditures	52,142	53,648
Project Aid	40,541	30,000	Project Aid	40,541	30,000
Total	263,888	218,204	Total	263,888	218,204
Government Savings (21,903)		75,323			
		6,248			

Source: Ministry of Finance.

TABLE A1.2
The 1999/2000 and 2000 Government Budget
 (Rp billion)

Item	1999/2000 Budget	2000 ^a Budget
I. Total Revenues and Grants	129,203.8	137,695.7
A. Domestic Revenue	129,203.8	137,695.7
1. Tax Revenue	99,480.7	97,780.7
a. Domestic Tax	93,935.9	91,881.9
(i) Income Tax	45,367.0	53,018.5
- Non-oil and Gas	40,626.0	44,188.9
- Oil and Gas	4,741.0	8,829.6

Item	1999/2000 Budget	2000 ^a Budget
(ii) Value-added Tax	34,597.4	26,258.4
(iii) Land and Building Tax	3,247.0	2,900.7
(iv) Excise Tax	10,160.0	9,271.8
(v) Other Taxes	564.5	432.5
b. International Trade Tax	5,544.8	5,898.8
(i) Import duties	2,950.3	4,976.3
(ii) Export tax	2,594.5	922.5
2. Nontax Revenue	29,723.1	39,915.0
a. Natural Resources	18,119.8	30,319.0
(i) Oil and Gas	16,224.0	28,629.1
(ii) Other Natural Resources	1,895.8	1,689.9
b. Profit Transfer from SOEs	4,000.0	4,000.0
c. Other	7,603.3	5,596.0
B. Grants	0.0	0.0
II. Expenditures	212,699.0	183,069.2
A. Current Expenditures	150,951.7	143,682.3
1. Personal Expenditures	33,569.1	29,355.1
2. Material Expenditures	11,039.0	8,940.5
3. Regional Expenditures	19,497.6	17,105.0
4. Interest Payments	54,526.0	58,989.9
a. Domestic Debt	34,000.0	42,364.9
b. External Debt	20,526.0	16,625.0
5. Subsidies	28,020.8	26,666.4
a. Petroleum Subsidy	9,955.8	18,300.0
b. Nonpetroleum Subsidy	18,065.0	8,366.4
6. Other Current Expenditures	4,299.2	2,625.4
B. Development Expenditures and Net Lending	61,747.3	39,386.9
1. Rupiah Financing	31,747.3	23,356.9
a. Transfer to Regions	16,129.3	15,139.4
b. Financing Managed by Central Government Institution	15,618.0	8,217.5
2. Project Financing with Foreign loans	30,000.0	16,030.0
III. Overall Balance	(-83,495.2)	(-45,373.5)
IV. Financing Net	83,495.2	45,373.5
A. Domestic Financing	30,000.0	22,189.5
1. Domestic Bank Financing	0.0	0.0
2. Domestic Nonbank Financing	30,000.0	22,189.5
a. Privatization Proceeds	13,000.0	5,939.5
b. Assets Recovery	17,000.0	16,250.0
B. Foreign Financing Net	53,495.2	23,184.0
1. Gross Drawing	77,000.0	31,780.0
a. Program Loan	47,000.0	15,750.0
b. Project Loan	30,000.0	16,030.0
2. Amortizations	(-23,504.8)	(-8,596.0)
Memo: Gross Domestic Product (GDP)	1,224,200.0	910,431.7

^a The 2000 budget is only for nine months starting in April and ending in December 2000. In January 2001 the new budget will begin.

Source: Ministry of Finance.

Appendix 2

Historical Exchange Rate of the Rupiah

End of Period	Rate
Annually	
1994	2,200.00
1995	2,308.00
1996	2,383.00
1997	4,650.00
1998	8,025.00
Monthly	
Oct 97	3,670.00
Nov 97	3,648.00
Dec 97	4,650.00
Jan 98	10,375.00
Feb 98	8,750.00
Mar 98	8,325.00
Apr 98	7,970.00
May 98	10,525.00
Jun 98	14,900.00
Jul 98	13,000.00
Aug 98	11,075.00
Sep 98	10,700.00
Oct 98	7,550.00
Nov 98	7,300.00
Dec 98	8,025.00
Jan 99	8,950.00
Feb 99	8,730.00
Mar 99	8,685.00
Apr 99	8,260.00
May 99	8,105.00
Jun 99	6,726.00
Jul 99	6,875.00
Aug 99	7,565.00
Sep 99	8,386.00

Source: Bank Indonesia.

Appendix 3

Breakdown of Recapitalization Bonds

Type	Series	Tenor (yrs)	Amount Issued		Total	Coupon Rate	Coupon Paymets
Floating			May-99 (Rp bn)	Oct-99 (Rp bn)	(Rp bn)		
	1	3	2,807	2,913	5,720	SBI 3 mos.	Quarterly
	2	4	2,807	2,913	5,720		
	3	4	3,378	3,506	6,883		
	4	5	3,378	3,506	6,883		
	5	5	4,091	4,246	8,338		
	6	6	4,091	4,246	8,338		
	7	6	4,948	5,135	10,083		
	8	6	4,948	5,135	10,083		
	9	7	5,947	6,172	12,119		
	10	7	5,947	6,172	12,119		
	11	8	7,184	7,456	14,639		
	12	8	7,184	7,456	14,639		
	13	9	8,706	9,036	17,742		
	14	9	8,706	9,036	17,742		
	15	10	10,514	10,912	21,426		
	16	10	10,514	10,912	21,426		
		<i>Subtotal</i>	<i>95,149</i>	<i>98,749</i>	<i>193,898</i>		
Fixed	1	5	2,170	1,063	3,233	12%/annum	Semi-Annual
	2	10	6,511	3,188	9,700		
			<i>Subtotal</i>	<i>8,682</i>	<i>4,251</i>		
Inflation-indexed	Issuance Date	Maturity Date	Amount (Rp bn)				
	Sep 98	17 Oct 2017	80,000				
	Oct 98	18 Apr 2018	20,000				
	Feb 99	18 Aug 2018	64,536				
	May 99	18 Dec 2018	53,780				
		<i>Subtotal</i>	<i>218,316</i>				
Total					425,147		

Source: Ministry of Finance.

Appendix 4

Inflation (CPI)
(percent)

Date	Month-on-Month	Year-on-year	Cumulative, 12 Months
Dec 90	0.06	9.93	9.53
Dec 91	0.19	9.93	9.54
Dec 92	0.66	5.04	4.93
Dec 93	0.53	10.18	9.77
Dec 94	0.52	9.64	9.25
Dec 95	0.79	8.98	8.65
Dec 96	0.55	6.63	6.47
Jan 97	1.03	5.45	5.34
Feb 97	1.05	4.78	4.69
Mar 97	(0.12)	5.29	5.17
Apr 97	0.56	5.05	4.94
May 97	0.19	5.19	5.08
Jun 97	(0.17)	5.09	4.98
Jul 97	0.66	5.07	4.97
Aug 97	0.88	5.71	5.58
Sep 97	1.29	7.11	6.90
Oct 97	1.99	8.80	8.48
Nov 97	1.65	9.96	9.56
Dec 97	2.04	11.60	11.06
Jan 98	6.89	18.07	16.91
Feb 98	12.75	31.73	28.60
Mar 98	5.49	39.13	34.22
Apr 98	4.70	44.87	38.36
May 98	5.24	52.17	43.41
Jun 98	4.64	59.50	48.22
Jul 98	8.56	72.01	56.12
Aug 98	6.30	81.24	61.53
Sep 98	3.57	85.33	63.82
Oct 98	(0.27)	81.22	61.56
Nov 98	0.08	78.43	59.99
Dec 98	4.00	81.85	61.95
Jan 99	4.00	76.93	59.06
Feb 99	1.26	58.91	47.57
Mar 99	4.00	56.67	46.08

Appendix 5

Summary of the Term Sheet of the Recapitalization Bond, Variable-rate Series¹

General Conditions

- **Issuer** Government of the Republic of Indonesia
- **Legal Bases** Government Regulation No. 84, 1998, regarding Recapitalization Program of Commercial Banks; Presidential Decree No. 55, 1998 regarding Domestic Debt in the Form of Bonds; Ministry of Finance Decree No. 183/KMK 017/1999 dated 28 May 1999 on Bond Issuance for the Purpose of Commercial Bank Recapitalization and Restructuring
- **Legal Status of the Bonds** Unconditional Obligation of the Republic of Indonesia

Structure

- **Offering Price** 100 percent of nominal face value
- **Nominal Value per Unit** Rp1 mn
- **Issue and Maturity Dates** Depending on series types
- **Coupon** For fixed-rate bonds, 12 percent for the 5-year series and 14 percent for the 10-year series. For variable-rate bonds, for the second coupon dates and henceforth, the rate is that of the latest SBI 3-month auction value (calculated to 5 decimal digits). The Ministry of finance fixes the first coupon.
- **Coupon Rate Announcement** Bank Indonesia will make public the rate at least two working days before respective coupon dates
- **Coupon Dates** Payments are made every three months on 25 January, 25 April, 25 July and 25 October, which pays out one fourth of the coupon for each bond unit
- **Rights to Payments** Investors listed as legal bond owners at Bank Indonesia and owner of the right of benefit at custodian agencies

1. Free translation by author; source of the Bahasa Indonesian original: Ministry of Finance.

- **Alternative Coupon** In the event that for six calendar months there is no three-month SBI auction, then the coupon rate of this bond will be based on other three-month government papers with auction method similar to SBI. In the event there is no alternative basis, the latest three-month SBI auction rate will be used. The alternative coupon rate will be announced at least 30 days before it becomes effective.
- **Call Option** The Government retains the right to purchase the bonds at market price. Bank Indonesia will announce any purchase at any period in the week afterward.
- **Redemption** Redemption is at 100 percent of face value

Other

- **Administering Agent** Bank Indonesia
- **Paying Agent** Bank Indonesia
- **Basis of Law** Laws of the Republic of Indonesia

Appendix 6

Historical Data on Government Budget
(Rp billion)

Item	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98
Total Revenue	48.9	56.5	65.1	71.9	88.9	108.0
Taxes	45.4	49.2	57.9	64.8	78.2	101.6
Oil and Gas	15.3	12.5	13.5	16.1	20.1	30.7
Non-oil and Gas	30.1	36.7	44.4	48.7	58.1	71.0
Nontax Revenues	3.0	6.9	6.7	6.6	10.2	6.4
Grants	0.5	0.4	0.5	0.5	0.5	—
Total Expenditure	52.9	58.3	64.4	65.8	81.2	115.8
Current Expenditure	25.5	30.6	33.9	38.3	50.0	70.3
Personnel	9.6	11.1	12.6	13.0	14.5	18.1
Goods Procurement	2.9	3.0	4.3	5.2	8.1	6.7
Subsidies	0.9	1.5	1.5	0.1	1.6	20.9
Interest on External Debt	5.4	6.2	6.1	6.6	6.6	11.3
Others	6.7	8.8	9.4	13.4	19.2	13.3
Development Expenditures	27.4	27.7	30.5	27.5	31.2	45.5
Current Balance	23.4	25.9	31.2	33.6	38.9	37.7
Overall Balance	(4.0)	(1.8)	0.7	6.1	7.7	(7.8)
Financing	4.0	1.8	(0.7)	(6.1)	(7.6)	7.8
Domestic Bank Financing	2.6	—	(2.1)	(6.8)	(6.6)	(2.5)
Recovery of IBRA Assets	—	—	—	—	—	—
Privatization Proceeds	—	—	1.7	1.7	1.4	—
Net Foreign Financing	1.4	1.8	(0.3)	(1.0)	(2.4)	10.3
Memo: GDP at Market Price	294.6	342.4	399.4	473.0	555.6	666.4

Source: World Bank.