

**Corporate Governance and
the Indonesian Financial System:
A Comparative Perspective**

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Discussion Paper No. 16

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Discussion Paper Series
APEC Study Center
Columbia Business School
August 2001

Paper prepared for the Columbia University CSIS program in
Indonesian Economic Institution Building in a Global Economy

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1. Introduction

Financial systems reform and corporate reform are deeply intertwined; they have to be addressed simultaneously and comprehensively. Indonesia is seeking to do this by developing rules, institutions, and mechanisms to achieve good corporate governance, while working to build an effectively functioning financial system that facilitates good corporate governance. This paper explores this in a comparative context.

As in every country, Indonesia has a wide spectrum of financial institutions and financial markets. They range from large, somewhat sophisticated financial institutions – large domestic and foreign banks, insurance companies, and the capital market – which engage in very large (wholesale) financial transactions with large enterprises, to “retail” finance for SMEs and individual depositors and borrowers, to micro finance – credit cooperatives, rotating credit cooperatives, moneylenders – for the smallest, predominantly rural producers in informal markets. In the process of economic development the formal financial sector is dominated by banks which tend to finance large firms and trade, both foreign and domestic. Formal and informal financial markets co-exist, segmented essentially by scale and creditworthiness of borrower. As the saving rate increases, and banks are increasingly able to attract them, the financial intermediation process develops and spreads. There is a trickle-down effect: the formal financial system gradually supercedes the informal system for more and more clients, both savers and borrowers. At the same time traditional small-scale informal financial institutions evolve into more formal, “modern” financial institutions. Moneylenders start local banks and credit associations; highly personalized rotating credit cooperatives evolve into mutual savings and loan associations and then banks.

Nonetheless, the key issue for the lender (creditor) at every level of finance – from the most formal, most sophisticated to the most informal, simple, from wholesale to micro transaction – is the likelihood of repayment (or default). For the borrower the key issue is the availability of credit. And for both it is a matter of cost – transactions cost, risk premium, basic cost of funds. Evaluation of risk is closely related to the trustworthiness of the borrower, and thereby to corporate governance.

The paper is organized as follows. The next two sections provide some general observations and suggest lessons derived from the experiences of other countries. One core of the paper considers the corporate governance of companies and business groups, and considers the Korean case for comparison. The other core is the ensuing discussion of the role in corporate governance of monitoring by the capital markets and particularly by banks, with issues relating to relationship banking and deposit insurance addressed. Given their needs for external finance, all growing companies in Indonesia, large and small, listed and unlisted, private sector and state-owned enterprises, borrow from banks to the extent possible, so the bank monitoring function is of transcendental importance. Following this discussion, I then look at Indonesia’s banking mess and the key issues for reform.

The political economy of Indonesia’s large-scale industrial structure is two-fold: business groups of allied firms under common control, typically by family-based (and frequently) founding owners; and state-owned enterprises. While beyond the scope of this paper, it should be stressed that the implementation of good corporate governance rules and practices for state enterprises is

at least as important as for private listed companies. Because of their central importance, business-group corporate governance issues will be raised throughout this paper.

2. Some General Observations

Indonesia – with its population of 214 million (fourth largest in the world), huge natural resource base, and strategic location – achieved 25 years of increasingly successful GDP growth until the Asian crisis in 1997. Still, per capita income is relatively low. The World Bank classes Indonesia as a lower-middle economy based on GNP per capita.

Indonesia's pre-crisis growth benefited substantially from taking increasing advantage of an open global economy. Indonesia's non-oil exports increased rapidly, and substantial technology was transferred in. However, even in the pre-crisis period, growth was being undermined by a domestic economic system that failed to implement needed economic and institutional reforms, and which became increasingly inefficient and corrupt.

The Asian economic crisis was devastating for Indonesia. For a variety of reasons, political as well as economic, the decline in GDP in 1998, 13.1%, was far greater than in any other Asian nation, and the recovery has been slower. Despite good growth of 4.8% in 2000, and a projected 4.8% in 2001 and 5.5% in 2002 (Nomura, 2001), not until 2002 will Indonesia reach its 1997 level of output, and several years beyond that before pre-crisis levels of GDP/capita are restored. The rupiah, which at its lowest point had temporarily depreciated by 86%, has been subject to wide fluctuation and remains weak. The overhang of foreign debt, both governmental and private sector, is very large, \$140 billion in 2000, 91% of GDP (Nomura, 2000). Economic recovery has been led first by exports, increasingly competitive as a consequence of rupiah depreciation, and more recently by domestic demand growth. The top ten company leaders in fact are mainly engaged in the domestic market, including top-ranked Astra International (Dhume, 2000). (For semi-annual updates on the Indonesian economy, see Asian Development Bank, Asian Recovery Report.)

Looking ahead, growth estimates range widely, which is not surprising given the political uncertainties of economic policy. Panggabean (2000, p 56) optimistically projects 6% to 2005, and 8% for the five years after that. The World Bank is more cautious, suggesting the potential is in the 4% to 6% range, and stressing that it depends more than in the past on achieving productivity increases. For comparison, average annual output per capita during 1980-95 grew at 5.0%, but total factor productivity increased at just 0.9% (World Bank 2000, p 144).

Concurrent with the economic crisis, which at the least has been its catalyst, Indonesia is in a profound political transformation. It has rejected the increasingly corrupt and nepotistic Suharto authoritarian regime, and is creating a fledgling democracy in a highly pluralistic system of many political parties, no one of which has majority control. The election of Abdurrahman Wahid as President in fall 1998 was a major step forward, but democracy is still nascent. Wahid has not demonstrated the leadership and decision-making capabilities to overcome the various and frequently divergent interests of Indonesia's diversified power elite, those powerful politically, economically, militarily, or traditionally. The imperatives of politics have slowed economic reform. The political tensions and difficulties in making and especially implementing economic

policy have reflected ongoing conflicts between the old Suharto-based elites and other established elites, between President Wahid and Vice President Megawati and their respective political parties, between the elites and the new group of technocrats and other reformers, and with the population at large, particularly the media, professionals, academics, and businessmen. It remains to be seen how President Megawati will handle these issues.

2.1 Grasping the Opportunities

Fledgling democracy provides the opportunity to reduce the power of the ruling elites by disclosure, transparency, the reduction of governmental preferential treatment for elites and other forms of corruption, and the establishment of economic institutions for the development of a competitive, market-based economy. Comparative analysis indicates that five types of institutions are essential to make markets work efficiently and properly. They are: property rights and their enforcement through laws and the operation of courts; regulatory institutions, including those to prevent monopoly and enhance competition, and to provide prudential supervision of the financial system; institutions, such as government budget rules and policies and an independent central bank, to achieve and maintain macroeconomic stability; institutions for social insurance and poverty alleviation; and institutions for conflict management, both public and private (Rodrik, 1999).

Despite the slowdown in the global and U.S. economies in 2001, the global economy and its international economic institutions provide opportunities for future Indonesian growth – export markets, sources of capital, and especially technology. Global economic opportunities still are increasing, especially as the information technology revolution develops and spreads over the longer run. But there is a real danger that, without creation of an appropriate domestic environment, Indonesia will not be able to take advantage of these opportunities. It is essential for its sustained, rapid, long-term development that Indonesia creates a market-oriented, competitive environment. This requires building institutions and implementing policies to ensure a good competition policy and good corporate governance (as well as good government). It also means obtaining the technological, managerial, and other benefits of foreign direct investment (FDI).

A prerequisite for any of this to be possible is a change in the mind-set of Indonesian policymakers from cronyism and state-ism to openness and markets. A reasonable degree of political stability and a credible, trusted government are important preconditions for sustained economic growth, and for deeply needed policy and institutional reforms. Although Indonesia's efforts to create a democratic and stable society are key, the relatively weak Wahid government has yet to design, much less to implement, a comprehensive economic strategy. In particular, the government's commitment to competition is weak and ambiguous. Powerful political and historical forces continue to foster special programs to benefit various interest groups at the expense of economic efficiency and growth.

2.2 The Business Need for External Finance

The main driver of rapid economic growth in every country is business investment. In a

rapid-growth environment, companies must rely heavily on external sources of finance because profits and cash flow are insufficient to finance investment internally, even if profits rates are high. In developing countries in particular, the main source of external finance is bank loans; stock and bond markets typically have only a limited role until later in the development process.

Indonesia is no exception. Although the development of stock and bond markets is a high long-term priority, at least in the medium-term bank loans will continue to be the main source of external finance for all but a few large firms. Accordingly, banks will be in a position to play a significant corporate governance role by monitoring business client performance and management behavior.

An unpalatable reality is that for the foreseeable future Indonesia would benefit from huge amounts of foreign investment, both direct (by companies) and portfolio (by institutional investors). However, there is fear, or at least anxiety, among Indonesian policy members and the population at large about the role of foreign investors in the economy. Equally important, foreign investors at present have deep skepticism regarding Indonesia as a place to invest.

Foreign investors bring important assets to Indonesia: capital, technology, management skills, and access to international markets. In Indonesia as elsewhere, foreign institutional investors also are likely to be the most effective demanders of good corporate governance (see Khanna and Palepu (1999) for the case of India) and monitors of the Indonesian firms in which they invest. They are independent, and they have a strong financial stake in the performance of the firms they fund.

2.3 Old Models, New Models

Indonesia's transition a half-century ago from colonialism to independence was accompanied by a state take-over of Dutch enterprises. More importantly, tenets of a socialist economy became embedded in the Constitution and in the mind-set of many policy makers and intellectuals. Moreover, the lack of a well-developed indigenous entrepreneurial class was and still is used as a rationale for an active, interventionist role of the government (Simanjuntak, 2001).

The global failure of socialism as a means to sustainable economic development makes it clear that a socialist model is not an effective form of economic organization. Still, governments often mistrust markets, and tend to emphasize their failures rather than seeking to utilize their advantages. Thus, most governments have tendencies to intervene substantially in ways that, intentions notwithstanding, can hinder a nation's productivity growth, as well as restrict improvements in transparency, disclosure, and governance. Bureaucratic failure is often worse than market failure.

Of course, interference in economic activity by politicians and bureaucrat is not simply ideological, it is very self-serving. This certainly seems the case for Indonesia, as its crisis has uncovered extensive corruption, only partly exposed by a series of publicized scandals. Politics still transcend economics, and that inhibits the transition to a competitive, market-based economic system.

Two general models of capitalistic economic development are in competition: the so-called East Asian model, which derives from Japanese early postwar developmental experience; and the Anglo-American model, sometimes termed the “Washington consensus”. While there are substantial similarities, notably in their common primary emphasis on markets and property rights, the differences are significant. To summarize briefly, the East Asian model is export-oriented, relationship oriented, bank oriented, and emphasizes a substantially greater degree of active state intervention, involving cooperation among government and business policymakers, to overcome perceived market failures and implement “industrial policy”. The Anglo-American model is free trade oriented, market oriented, capital market oriented, and emphasizes much less state intervention, limited to provision of necessary economic institution infrastructure, physical infrastructure (such as roads), and public goods (such as education and defense).

The Asian crisis brought the East Asian model into some disrepute, mainly because in a number of countries relationships had degenerated into cronyism, corruption, and nepotism. Nonetheless, in his review Park (2001) argues that the East Asian model, once successfully corrected for these negative features, remains appropriate for the developing economies. A related, longer-run issue is whether, as economies develop and markets function better, the East Asian model will converge to the Anglo-American model. Contemporary Japan suggests that is the case in the large, though not in the specifics, since each country’s values, existing institutions, and history affect the precise forms of its economic system. (A study of the negative role of the Japanese state in limiting competitiveness is Porter, Takeuchi, and Sakakibara [2000].)

Despite the inappropriateness of the old models, a transition in Indonesia to a market-based competitive system is by no means a given. The fundamental problem is the lack of a strong policy commitment to competition, despite IMF and World Bank prodding. State-ism and cronyism persist as powerful forces.

2.4 Relationships and the Rule of Law

In all countries, the economy combines formal and informal rules with personal and institutional relationships. Rules for economic efficiency and social equity are at times in conflict with relationships based on societal and religious values, as well as those representing regional and historical ties, ideology, and power. Indonesia has a traditional system of complex, intertwined social and personal hierarchies and patronage relationships which permeate the economy and society. Historically there have always been close ties between the rulers and the business elite (Simanjuntak 2000 and 2001).

Fundamentally, good relationships are essential for doing business on a sustained basis in any economy, whether founded on the Anglo-American or the East Asian model. They can reduce transactions costs significantly. Relationships are a substitute for law only when the legal system, including its enforcement mechanisms and practices, is poor and weak. Where the rule of law works well, law and relationships are complementary mechanisms for making and enforcing business transactions.

Where information is poor and, concomitantly, uncertainties are great, relationships based

on trust can generate not only effective but quite efficient economic decisions. A major problem however, is that the powerful can and often do misuse their relationships to obtain more income and wealth, often through inefficient allocation of capital, government licenses, and other resources. This is the essence of what is termed corruption, collusion, and nepotism (KKN in the Indonesian acronym). It is also why much of the institutional reform underway or being considered aims to reduce the role of patronage relationships.

The rule of law is essential. Although good laws (contracts, prudential regulations, bankruptcy provisions, competition rules, corporate governance, foreign direct investment, and so on) are important, even more essential is their effective implementation. One of Indonesia's greatest economic weaknesses is the lack of an honest and effective legal system. Legal reform, including reform of the courts, must be of high priority.

3. Some Lessons from Comparative Experience

Financial crises have occurred in both developed and developing countries over the last several decades, in many cases seriously harming the industrial sector as well. Indonesia is one of the worst cases. This is in large part because the crisis has been intertwined with dramatic political regime change and reforms that have substantially affected and slowed the economic policy responses.

The concurrent experiences of Thailand and South Korea are particularly relevant for Indonesia because they faced similar external shocks and domestic weaknesses, as did Mexico in the mid-1990s. In all four cases, the immediate vulnerability came from immense company and bank short-term unhedged foreign currency (dollar) borrowings. These positions were taken in order to benefit from the large differentials between domestic and foreign interest rates, in Indonesia on the order of 9%, combined with an expectation that the foreign exchange rate would not depreciate more than about 4% annually.

Unhedged short-term foreign borrowing by banks and companies entails great risks. The probability of the risks may be low, but their consequences are disastrous. That is one great lesson from the Asian crisis.

For Indonesia, the rupiah depreciation and the capital flight of 1997 exposed the underlying weaknesses of banks and other financial institutions, precipitating a financial crisis. The financial crisis in turn exposed the weaknesses of many companies, and particularly the business groups. The weaknesses have resulted in industrial and economic distress.

In many respects, Indonesia has on the books quite good prudential and other laws and regulations; the central problem has been their complete lack of effective implementation and, indeed, their being sabotaged by collusion, corruption, and nepotism (KKN).

It is clear that the costs of delay in addressing systemic problems not only are high, they increase over time. The greatest cost is the GDP lost by not restoring growth. Forbearance – policies that protect insolvent financial institutions and companies from bankruptcy, and delay tackling the inherent problems of economic failure – is particularly tempting but dangerous, as the experience of other countries (most notably Japan, which lost a decade of growth in the 1990s), well demonstrate. Forbearance makes economic sense only when the problems are limited and will be solved by the restoration of growth and the increases in demand and asset prices that growth generates. The reality is that policies of forbearance are unsuccessful and costly for all Asian market economies, ranging from Japan to Indonesia. This is a second great lesson.

3.1 Debt-Equity Ratios

In rapidly growing market economies, high debt-equities ratios are virtually inevitable for almost all companies. Rapidly growing companies need to expand capacity and staff, and rarely can finance growth from profits and depreciation cash flow without recourse to substantial external finance. Particularly in developing countries, capital markets are small; typically their development follows, rather than precedes, development and growth of the economy, with stock markets developing before bond markets. (For an earlier analysis of the limited role of stock markets in developing countries and the costs of heavily-subsidized acceleration of stock market development see Wai and Patrick (1973).) With all but a few companies unable to finance new investment projects with equity or bond issues, bank borrowing is the primary source of external finance.

If high corporate debt-equity ratios are inevitable to sustain rapid business investment growth, then managing and controlling the attendant risks and vulnerability are very important – and not impossible. Japanese experience in the 1950s and 1960s high growth era is a salutary example. Debt-equity ratios for listed companies, and for the entire corporate sector including SMEs, exceeded 400% before receding in the 1970s and thereafter as investment slowed and cash flow continued. The keys to success were that the projects (which often embodied advanced imported technologies) were highly profitable, and domestic product markets were highly competitive. The profitability, and enhanced cash flow from depreciation allowances, well-serviced the debt, and made possible subsequent reductions in debt-equity ratios as economic growth slowed.

Korea also has experienced high corporate debt-equity ratios over the past several decades of rapid growth, but with very different, much more adverse consequences, than the Japanese case. While Korean business investment was very high, on average profits were low. Indeed, Korean development has been a case of “profitless growth”. Even prior to Korea’s late 1997 currency and financial crisis, some one-quarter of large and medium firms were not able to earn sufficient profits to cover their interest costs, much less repay debt. While the reasons for this inefficient allocation of resources have yet to be well analyzed, it seems that Korean entrepreneurs were caught up in the fallacious belief that sheer expansion of capacity and market share would

generate profits in the long run, and that the economy's rapid growth and government support would bail them out of any mistakes. Another important lesson: only highly profitable investment projects should be selected and financed.

Indonesian firms, both large and SMEs, will persist in having to rely heavily on external debt finance, with attendant high debt-equity ratios even if most profits are retained within the enterprise. This implies the vulnerabilities inherent in being highly leveraged will persist.

3.2 Corporate Governance Systems

Corporate governance rules, norms and procedures evolve gradually over time as firms develop and grow, as is reflected in the industrial and financial histories of the advanced industrial nations: the UK, the US, continental Europe, and Japan. The prototypical pattern is that a firm is founded by an entrepreneur and his family, who own, control, manage and finance it. Over generations, the successful firm grows and becomes large, and evolves from family to professional management, from family to more or less dispersed share ownership with public listing of the company on the country's stock exchange, and from informal to extensive, formal external finance. While this is the general pattern, there are considerable national and firm-specific variations in the nature and degree of separation of ownership and control, and some large firms remain under inherited family control. And of course there are always new firms which have grown rapidly and remain under founder control, such as Microsoft in the United States and many large companies in developing countries.

The essence of corporate governance lies in two related questions: who controls the corporation, and for what purposes? Corporate governance is predominantly a large corporation issue, since shareholders may delegate business operations and decision to managers. This is the prototypical principal-agent problem, where their respective interests can diverge. Small and medium-sized enterprises (SMEs) are private, family owned, controlled and governed. In Indonesia as in all countries corporate governance issues are most immediately relevant for three types of firms: those on the stock exchanges and hence with minority, outside shareholders; large private corporations, especially those part of a business group, whose failure or difficulties could have a major impact, especially on its creditor banks; and state-owned enterprises. Each is subject to moral hazard, broadly defined not only to include excessive risk-taking, but looting and other terms of mismanagement (as described in some detail in Simanjantak 2001), and unwarranted forms and degrees of government interference.

There are various national experiences of corporate governance systems, in both developed and developing economics. In all countries corporate governance rules and norms are evolving in response to new domestic and international forces such as technological innovation, financial liberalization and globalization to achieve good corporate governance and its benefits. While there appears to be some broad convergence in corporate governance rules and practices across nations, substantial specific differences will persist due to the path dependency effects of history and different institutions even where legal rules become the same (Bebchak and Roe, Nestor and Thompson). The sources of corporate governance change and improvement lie not only within the firm, but particularly within the financial markets, where lenders, bondholders, and shareholders condition the cost and availability of funds on good corporate governance and

performance, supported by government changes in relevant legal rules and their implementation, including those of standards-setting organizations of accountants and other professionals.

There are three general corporate governance models: the separation of company ownership and control because shareholding is widely dispersed; a dominant owner who exercises control and appoints management, and an intermediate case where a large shareholder (a blockholder in the terminology) has veto power over major management decisions. Shareholder control may be achieved through majority ownership, or indirectly through the pyramiding of share ownership through affiliated companies that are part of the (family-controlled) business group.

In Indonesia, Korea and indeed most developing economies there is no separation of ownership and control; owners control their companies even though they are listed. Given imperfect markets for finance and managerial talent, and perhaps limited supply of entrepreneurs, typically an owner of one large company owns several, and may own banks and other financial institutions. Accordingly, it is not surprising that such ownership leads to the formation of (family-owned) business groups, or conglomerates. The nature of business groups, and the Indonesian and Korean experiences, are considered in following parts of this section.

The other two corporate governance models – involving different degrees of separation of ownership and control – is applicable only to developed economies. The United States, United Kingdom and Japan are cases where shareholding is widely distributed, with no dominant blockholders. Even so, the US and the UK's degree of emphasis on shareholder value and external market disciplines is at the other extreme from the Japanese case. For continental Europe the intermediate blockholder model is in many cases the most relevant (Tiberghien, 2001).

The United States has strict laws and stock exchange regulations regarding disclosure, transparency, and other components of good corporate governance. The corporation's board is its basic decision-making unit, and it is composed of a majority of outside, independent directors, though the CEO (top management) typically plays a major role in board member selection. In the 1970s and 1980s, the threat of a hostile take-over bid was an important mechanism for protecting shareholder interests, and the norm is that the objective of management is to maximize profits and shareholder value (market capitalization). However, the hostile bid threat has become less effective as management has succeeded in implementing a series of protective measures – poison pills, golden parachutes, and the like. Today more important influences on outside directors to achieve good corporate governance and performance are activism by institutional shareholders such as CalPERS, TIAA-CREF, other pension funds, and unions; and by peer pressure by their business leader colleagues in other companies (Romano, 2000). As a consequence, the United States has the highest level of good corporate governance, in principle and in practice, of any country in the world. Yet it is still far from perfect, as reflected in the still fairly wide range of corporate performances by listed companies in any given sector. Interestingly, the McKinsey and Company survey (2000) suggest, investors were willing to pay a substantial premium (18.3%) for good corporate governance by American companies; while at the low end of the 22 country sample it was slightly above the UK, Switzerland, and Sweden.

The continental European corporate governance systems are significantly different in some respects from the market-oriented Anglo-American model. Each European country has its own

distinct laws, institutions and norms. Nonetheless, a common European pattern is that companies are controlled by a relatively small number of outsiders, through a two-tier equity structure in which some shares have extraordinary voting rights, and the others have few or no voting rights (Tagliabue, 2000). Many companies still have a large shareholder with considerable blocking power, frequently the family of the founder.

Corporate governance in Germany and Japan are often compared since both have relied heavily on relationship banking and monitoring by major bank creditors, in contrast to the greater reliance on capital market finance in the US and UK. At the same time there are significant difference between the German and Japanese systems of corporate governance. In Germany, according to Roe (1998), “85% of the large, purportedly ‘public’ firms have at least one blockholder owning more than a quarter of the stock”. In Japan a significant proportion of the shares of most companies are held by a substantial number of other friendly companies, epitomized by the financial keiretsu, though no single shareholding has unilateral blocking power.

In Germany codetermination (labor union representation on the board) is mandated; in Japan, as in most countries, there is no worker representation on boards. Germany has a two-tier board system (like Indonesia). Nonetheless, until fairly recently in both Germany and Japan banks have been the main agent for financial system monitoring of their corporate clients, and have provided equity finance as well as loans. In Germany a major source of bank influence on boards lies in their position as proxy-holders for shareholders to whom the banks provide custodial services (Baums).

Japan is the most extreme case of separation of ownership and control of listed companies in any country in the world. Management controls; shareholding is dispersed. The consequence has been a system in Japan of entrenched managerial autonomy and corporate governance by managerial self-restraint. Company management of course is not completely autonomous. It is constrained by four major stakeholders, in order of importance: its customers (which is true for all companies everywhere); its employees, especially those on the managerial track; its creditors, particularly its banks; and its shareholders. Management has to ensure adequate corporate performance to keep all its stakeholders reasonably content so they are not sources of trouble.

Japanese management has two fundamental, interrelated goals. The first is to maintain management independence and autonomy in a self-selected, self-perpetuating management system. The second is to ensure the independent survival of the firm in perpetuity. Bankruptcy and liquidation is the worst possible managerial outcome; selling the firm (usually termed merger) is the second worst.

While the objective is not maximization of profits or of shareholder value, in reality good profits are essential in order to buy off all the stakeholders. This was well understood by Japanese management in the 1960s and 1970s, when corporate growth was rapid and profit rates were high. However in the 1980s the focus on profits eroded, as reflected in the declining return on corporate assets (ROA). However, the continuing rise in land and stock prices, culminating in the boom of the late 1980s, flooded companies with unrealized capital gains which not only provided the resources to continue satisfying all stakeholders but shifted management attention away from operating profits while continuing on the path of ever more investment in plant and equipment and R&D, and generated self-confidence in the Japanese management system that at times bordered

on hubris. And then the twin huge bubbles of stock and urban real estate prices burst at the beginning of the 1990s.

Over time, management in Japan was increasingly able to entrench itself, thanks to rapid economic growth, sustained increases in stock and urban land prices, and the development and deepening of these institutional arrangements. The result was a system of cozy back-scratching, some might say collusion, among the management of Japan's large industrial companies and financial institutions and the government ministry bureaucracies, particularly the Ministry of Finance. The system was opaque, with minimal disclosure; forbearance was the policy stance, on the grounds that growth would make it possible to write off all mistakes and difficulties easily; and utilization of regulatory rents could solve other problems.

The permanent employment system, and effective cooperation between the enterprise's union and its management, made each the prisoner of the other in an increasingly cooperative game of sharing the economic benefits of good corporate performance. Top management received good but not shockingly high salaries, and excellent, if not disclosed, pensions and perquisites for life. When times became so difficult, as they have over the past decade, that the workforce had to be reduced, it was done not by layoffs but by a negotiated combination of attrition, early retirement with special benefits, and transfer of workers to subsidiary or other related firms.

The foremost management priority regarding shareholding was to ensure that a majority of shares were held by friendly other companies – suppliers, customers, and especially financial institutions. The horizontal financial keiretsu epitomized this system, which embodied considerable cross-shareholding among companies, but this management strategy was implemented virtually by every company. After all, no one wanted to be subject to potential hostile take-over bids. At the same time, share-holding enhanced beneficial business relationships, certainly an important objective. The implicit management agreement among firms was not to interfere with each other's affairs. While cross-shareholding has decreased significantly in the past five years, the stable shareholding ratio for industrial company shares did not decline at all between 1988 and 2000; banks and insurance companies significantly reduced their holdings, but that was fully offset by increases in shareholdings by related companies. Management protection from hostile take-over bids remain alive and well so far.

Until the 1980s, the dominant source of much-needed external finance, for large companies as well as small, was loans from the banks. Relationship banking, epitomized by the main bank system, was the norm (Aoki and Patrick). There were very few cases of large firm failure or even major difficulties until the 1990s. The main bank was presumed to have access to privileged information from its clients and to monitor corporate performance and behavior on behalf of all creditors. With financial deregulation and the development of the corporate bond market, the financial dimension of corporate governance evolved from main banks to the bond and stock markets in which creditworthy major firms were able to finance their activities at lower cost. It is the rewards and punishments of the financial markets that now are increasingly subjecting management to corporate governance. Corporate credit ratings by private rating agencies affect their cost of borrowed funds. Stock market prices, and the widening divergence of prices among firms within the same industry, now signal investor perceptions of management

performance.

The shareholders of Japanese companies can be classified into four groups. One is the set of financial institutions which provide credit and other financial services – the main bank, other core banks, life and casualty insurance companies, and securities companies. Together they hold up to 20 – 30 % of the shares, and play a significant, albeit decreasing, role as monitor for corporate governance purposes. The second group consists of other industrial companies, each of which holds a small percentage but which cumulatively accounts to another 20 – 30 %, based on business relationships. The third group, typically no more than a quarter of a company's shareholding, are individual and outside institutional investors. In recent years, foreign institutional shareholding has risen rather sharply to about 20 %, focused on a subset of companies considered attractive. They are a new force in seeking better Japanese corporate governance, and have added a new dimension; for the first time CEOs of some major Japanese companies are making trips to the United States to meet their institutional investors.

The bursting of the asset bubble and subsequent decade of miserable economic performance have seriously frayed this opaque managerial system. Unrealized capital gains on land and shares evaporated. Profits and the return on assets declined. Huge amounts of loans, especially to real estate, construction, and supermarket companies, turned into huge losses; non-performing loans became, and remain, a major problem. Lack of demand forced companies to cut costs and reduce their number of employees.

Corporate governance reform has become the new rhetoric in Japan. However, it has not altered management's objective: to stay in power with minimal outside control or pressure. This is why companies are suddenly emphasizing the importance of adequate profits (though not profit maximization): to be able once again to placate the major stakeholders. In practice, most corporate governance reforms thus far have been initiated by such government requirements as consolidated balance sheets, mark-to-market pricing of several classes of corporate assets, and strengthened auditing.

3.3 Business Groups

Conglomerates, typically family-owned groups of related companies, are a virtually ubiquitous feature of non-socialist developing economy industrial organization. There is a large literature on such business groups, although much of it is country- or region-specific, with a particular emphasis on Asia. There are two strands in this literature, reflecting research (by economists) on industrial organization, transaction costs, and the theory of the firm, and (by sociologists and business school faculty) on the embeddedness of business networks and supply chain management (Feenstra, Huang, and Hamilton 1997).

Nathaniel Leff (1997, 1978) was an economist who early on identified business groups as an important feature of developing countries. "Zaibatsu" (Japanese prewar family-owned groups), "keiretsu" (Japanese postwar affiliated firms with no central control), and "chaebol" (Korean groups) have all entered the English language, albeit not necessarily with the same implications as in the source language. Overseas Chinese business groups, notably in Southeast Asia and

especially in Indonesia, have been identified and studied, although it is very difficult to obtain detailed information on their internal operations and policies (Government of Australia 1995).

It is beyond the scope of this paper to consider the causes of the emergence and development of the various business groups models, but several points are appropriate here. The groups seem to have developed to solve the problems for firms of market failures or inadequacies, and to achieve economies of scope. Generally, it is easier to finance group investment and production by interfirm financial arrangements than by going to external capital markets. For this reason business groups try to include banks and other financial institutions within their domain. External labor markets for skilled, trustworthy managers are nascent; internal transfers of trusted managers are more effective. Similarly technological skills and entrepreneurial talents are in short supply, and can be more effectively mobilized within the business group. And of course nepotism is the basis of senior management since after all these are family-controlled organizations.

Chang and Hong (1999) show efficiencies in Korean business group transactions among member firms. Group transactions substitute for legal contracts. Fisman and Khanna (1999) argue that business groups respond to circumstances where basic services required to support economic activities, including legal enforcement of property rights, are weak or lacking. More broadly, Khanna in various writings refers to the need for the “soft infrastructure” of institutions and professional skills to make markets and the economy work more effectively.

Business groups typically are effective rent-seekers of government largesse. Being relationship-oriented, secretive, not subject to outside scrutiny, and often linked to the specific benefits governments can confer (licenses, contracts, cheap credit, etc), the groups often are major instruments of collusion, corruption, cronyism, and monopolistic practices. The terminology is indicative: from networks to relationships, to cronyism, to corruption.

Business groups exponentially increase the problems and difficulties of achieving good corporate governance. Their activities often are secretive and opaque. Typically, some group firms are listed on a stock exchange while others are not. Transactions between listed and unlisted members provide significant opportunities to exploit minority shareholders and creditors. In short, groups are particularly difficult to monitor in any country (Khanna and Palepu 1999).

Governance of large business groups is even more important politically and socially than in terms of the rights of minority shareholders, since the groups typically have significant power (political influence). The “iron triangle” of politicians, government bureaucrats, and business group leaders is strong, mutually reinforcing, and highly non-transparent. (For the Korean case, see Woo 1991.) Indeed, the development and growth of large business groups in virtually every developing country has been abetted by strongly supportive governmental policies. Large business groups often have been major financial supporters of those in political (and military) power. Not surprisingly, the groups are able to exert political influence, usually behind the scenes, to prevent policies regarding disclosure, protection of minority stockholders, ending of corrupt practices, and other good corporate governance measures.

Suppose a business group is very large but entirely privately held, so protection of

outsider shareholders is not an issue. Should society care much about the governance practices of the owners, or be concerned if they pursue objectives other than group profit maximization? The answer is clearly yes, because there are a range of public policy issues and social effects that should be taken into account, even aside from the close state-group relationships discussed above.

If banks and other creditors provide huge loans to a group that falls into difficulty, the banks are in trouble. The policy temptation to bail out the bank by bailing out the business group is strong. There then is a danger that very large business groups will be perceived as “too big to fail”, with all the moral hazard difficulties that implies. In addition, where several groups have companies in the same oligopolistic industry, the potential exists for collusion, with trade-offs between firms strong in certain sectors and weak in others. (For the prewar Japan zaibatsu of “cordial oligopoly”, see Hadley (1971).)

3.4 Indonesian Business Groups

Indonesian private-sector big business and finance have been dominated by family-owned business groups, almost all of Chinese ancestry (Mackie 1990). Some, although by no means all, were extraordinarily close to the Suharto government and his family. Others were in opposition. Nonetheless, Indonesian business groups’ “Chineseness”, and their history of relations with the government (politicians and bureaucrats), make this a highly sensitive matter. Anti-Chinese Indonesian violence in spring 1998 accelerated the flight of capital, both human and financial, out of the country. The estimates of Chinese Indonesian capital parked in Singapore (and elsewhere) are as high as \$80 billion (The Straits Times, 19 Jan 2000).

Some comprehensive data on Indonesian business groups are available prior to the crisis. As in other countries, Indonesian business groups (conglomerates) range widely in size, scope, importance, and nature and degree of political connections. Prior to the crisis, some 300 business groups were identified, consisting of 9,766 business units. Their share of GDP, assuming a value added/sales ratio of 30%, was a stable 12.7-13.4% between 1990-1996 (Husnan, p. 10).

It is generally accepted that some 15 families, 14 of them Chinese Indonesians, are predominant; for example, as of 1996, they controlled 61.1% of all publicly listed companies, while other families control another 5.4% (Claessens et al, 1999a, Table 8.) The Suharto family was the largest group; it alone controlled 16.6% of the stock market total capitalization. The top five families controlled 40.7%, the top ten families 57.7%. The Salim Group, controlled by Soedono Salim, is generally recognized as the most prominent and coherent group. It was close to the Suharto government; Suharto family members were minority shareholders in a number of Salim Group firms. Estimates of the number of Salim Group member firms vary. Some 602 companies were related to the Salim group, of which 201, in a wide range of industries, were organized into four groups (Simanjuntak, 2001). Only a few of Salim Group firms are listed on the Jakarta stock exchange, but they are major firms. A number of major Salim Group companies and its bank (Bank Central Asia) were taken over by IBRA (The Indonesian Bank Restructuring Agency) and have been or are in the process of being sold in what have become controversial, politically charged transactions.

Each top business group controlled at least one bank, which served mainly to finance

group activities with little autonomous bank manager decision-making or objective investment project analysis. As the crisis unfolded, virtually all the banks were discovered to have made “connected loans” to group member firms far in excess of the legal limits, hence a major cause of their insolvencies.

Some of the groups related to officials have a unique share ownership. The officials (or their family members) often own a small portion of shares given to them freely as token from the controlling shareholders. By doing this, the controlling shareholders could maintain the special relationship with the officials, and hence, enjoy some kind of protection and special treatments. However, the control of the company is still in the hand of the founder or their family. (Husnan, p. 28)

The Asian crisis hit Indonesia business groups, both member companies and banks, particularly hard since they had relied so extensively on unhedged foreign loans. The extreme rupiah depreciation alone increased corporate liabilities so much as to make them virtually insolvent. These balance sheet problems were exacerbated by business group heavy reliance overall on debt in addition to equity finance, notably domestic loans from banks under group control. And their bank portfolios were excessively concentrated in loans to group members. A domino effect was in operation; the failure of one company led rapidly to failure both of the member bank and other member companies. That is how IBRA came to obtain control over so many corporate assets which had been put up as collateral.

The consequence was bankrupt or insolvent companies and banks, and debts far greater in some cases than the value of the assets IBRA took over. The gap has to be covered by the government (the taxpayers). As the most knowledgeable investors, the Chinese Indonesian business group owners are potential purchasers of the assets IBRA is selling (at substantial discounts from earlier values). The moral hazard problem is that these Chinese Indonesians will buy back their, or related, assets at excessively low prices, with outside shareholders and taxpayers bearing the excessive losses.

Yet it is widely believed that until Chinese Indonesian investors return, other foreign investors are unlikely to enter Indonesia. Thus, the government wants to attract their financial and human capital back. Yet this creates a difficult moral and political dilemma. Some business group leaders were cronies of the Suharto regime, corruptly receiving very valuable special economic benefits and privileges. Others were not so close, and may be less tainted by a Suharto relationship. One suspects that all were involved in one form of illegal activity or another, such as borrowing beyond the legal limits of their affiliated bank as one (probably relatively small) example. Yet many of these groups have important assets in addition to access to overseas capital, such as management skills and knowledge of their company operations. The very difficult policy problem for IBRA is to sort out the various shades of grey among potential buyers of IBRA assets, and to make the political decisions as to who will be barred from bidding for them. This is one reason IBRA’s asset sales have proceeded so slowly.

I anticipate that family-owned business groups will continue to be the dominant form of private sector big business organization in Indonesia for the foreseeable future, though the power, position, and role of specific families will undoubtedly change. As happened earlier in the

Philippines, a new group of entrepreneurial risk-takers likely will emerge to take advantage of the opportunities emerging in the new political economy. A similar pattern is now developing in Thailand.

3.5 The Korean Business Group Experience

Other Asian crisis countries are going through similar political economy experiences. The ongoing experience of reforming South Korea's business groups (chaebol) is instructive, and a useful model for Indonesia. Especially since the 1997-98 crisis, the Korean government has implemented strong measures to restructure the chaebol and impose good corporate governance by law and through deregulation.

Korea's structural reforms since 1997 have been on three fronts: corporate sector restructuring (focusing on the chaebol), corporate governance reform, and financial sector restructuring. A substantial literature on these topics builds on earlier research. (See Joh and Ryoo 2000, Kim 2000, Chang and Hong 1999, and the materials listed in their bibliographies.)

As a consequence of relatively low profitability and sustained rapid growth, almost all Korean firms have been vulnerable because of high debt-equity ratios. In the universe of 4056 firms with a minimum asset size of 6 billion won (about \$6 million) in 1996, 28% (1136 firms; 21% of total borrowings) were not able to cover their interest payments from cash flow (measured as EBITA - earnings before interest payments and taxes plus depreciation and amortization allowances). Of these 1136, 424 (37%) were chaebol members. Although the proportion among top-five chaebol was the lowest, the next 55 were in the worst shape.

Korea's business groups are heterogeneous. Size and diversity varies immensely. Some are insolvent, a few are in good financial and economic shape. It is standard in discussing the chaebol to separate them into the Big Five, the next 25, and the next 30; the other 400 or so identified by the Korean Fair Trade Commission (KFTC) are disregarded in most discussions as not being of sufficient size.

The KFTC defines a business group as "a group of companies more than 30% of whose shares are owned by some individuals or by companies controlled by those individuals" (Chang and Hong 1999). The KFTC identified 461 groups as of 1996. Of these, 144 were so small that at most only one of their members was listed on the Korea stock exchange or had assets of over 6 billion won (about \$6 million) if not listed.

There have been some spectacular cases of chaebol that have collapsed. In the wake of the late 1990s financial and economic crisis, the percentage of sampled firms unable to cover interest payments increased only slightly, to 31% at the end of 1998. However, the proportion of loans these firms represented increased dramatically, to 32%.

It was the second-tier chaebol (those ranked 6 to 60) that were reportedly in the worst shape. The number of their member firms decreased from 298 to 233, and the percentage not able to cover interest payments rose sharply, comprising 54% of the borrowing of the second-tier chaebol. (See Kim 2000, especially Table I-4.)

Until 1999 the Big Five – Hyundai, Samsung, Lucky Goldstar (LG), Daewoo, and Sunkyong – were considered "too big to fail". However, government reform efforts brought to light information that showed the core company of the Daewoo Group, and the group as a whole, were hugely insolvent, even though some member firms have net asset positions and good business prospects. Daewoo's subsequent collapse, fought every inch of the way by its founder, is resulting in the group's break-up, including the sale of some divisions and companies. The economy and financial markets, with government support, have been able to withstand the collapse of Korea's third largest group.

Hyundai, the largest chaebol, has also been going through a major restructuring, and indeed is dissolving. One of the more difficult problems was to wrest control from the founder (Chung Ju Yang), his sons and other family members, and loyal senior managers. Thus, the chair of Hyundai Securities Company and Hyundai Investment Trust Management Company, Lee Ik Chi, who has been regarded as the foremost ally of son Chung Mong Hun, resisted government reform demands for over a year. He finally resigned on 29 August 2000, after foreign investors had taken a 23.7% stake in the firms he headed. The saga of the ongoing dissolution of the Hyundai group reflects one of the major problems of family-controlled groups: infighting among the children of the founder for control. The recent death of the founder is the final catalyst in the restructuring process, as creditors force debt-for-equity swaps which are effectively removing Chung family members from control of some major Hyundai companies. Nonetheless, the Hyundai break-up will create three Hyundai-named groups in Korea's top 30 conglomerates (see [Kirk, 2001] to obtain some of the flavor of Chung family infighting).

Of the 25 groups in the upper second tier, 6 collapsed in 1997 under the weight of extraordinarily high debt-equity ratios (some more than 1000%) or outright insolvency, usually under scandalous circumstances. The affiliated firms are being liquidated, or restructured and sold. Owners have lost control and assets. New, more autonomous firms are supposed to emerge. The government has absorbed much of the corporate debt that firms cannot service, mainly by purchase from creditor banks and other financial institutions.

In addition to specific policies toward chaebol restructuring and governance – such as mandatory reduction of debt-equity ratios to 200% and elimination of cross-debt guarantees – corporate governance has been comprehensively improved through government policies specific to that purpose. Kim (2000, p 21) summarizes this nicely.

Corporate governance was swiftly implemented with major emphasis on transparency,

accountability, and information disclosure. Listed firms were required to appoint outside directors while the scope and the responsibility of directors were expanded. At the same time, various protective measures for minority shareholders were further strengthened. Last but not least, chaebol were required to produce combined financial statements.

Even more than in other countries, Korean business groups have relied upon external finance and, as already noted, had the highest debt-equity ratios in the region. They relied extensively on bank loans but, because of government policy, chaebol were not able to own or control banks. For an economy its size, Korea has had a relatively large number of nationwide banks, as well as a number of regional ones. Twice since the Korean War the banking system was nationalized and then resold to the private sector. After the last privatization, in 1982, concern about the strong economic and political influence of the chaebol led the government to impose strict conditions on bank ownership. Initially, there was an 8% ceiling on related-individual ownership; this was reduced to 4% in 1994.

Chaebol have had a high reliance on external funding, and faced with the ownership limits on commercial banks, they established or bought merchant banks, securities companies, investment trust companies, and non-life insurance companies. In getting control of major captive sources of finance, the chaebol were aided by the fact that basic prudential regulations and regulatory supervision of non-bank financial institutions were lax until after the 1997 crisis, and many would argue that subsequent improvement has not been sufficient.

Three-year (or shorter maturity) bonds have been a major source of the Big Five chaebol financing. Earlier they were guaranteed by commercial banks, making them in effect term loans. Since the Korean crisis, the bonds have been purchased by affiliated investment trusts (ITCs, similar to open-end mutual funds). The impact of the Daewoo collapse and Hyundai restructuring has been particularly negative for the trusts, and the government has had to inject huge amounts of funds into them to protect the public investors.

In Korea the focus has been on liquidating the clearly insolvent and restructuring the rest to make them efficient, profitable, and better governed. The business group system as such is not being dismantled. It is premature to say how successful Korea will be in establishing good corporate governance, especially in the chaebol. In May 2001 the government retreated somewhat on its chaebol reform program. Nonetheless, the government is demonstrating a combination of political will and well-designed reforms to carry out what will probably result in a major transformation of Korea's economic system. Despite some backsliding, it is a model for Indonesian policy makers to emulate.

4. Corporate Governance and Financial System Monitoring

Corporate governance involves both legal rules and their enforcement, and non-legal rules and norms which substantially shape management behavior (Milhaupt). A norm, as defined by Richard Posner, is a rule that has not been legally established and is not enforced by the threat of legal sanctions, yet is regularly complied with. In Indonesia prior to the crisis the norms of acceptable owner-manager behavior were very permissive, indeed routinely in contradiction to the

laws since they were not enforced. The Indonesian challenge today is not only to strengthen laws pertaining to corporate governance and enforcing them, but destroying old governance norms and creating new ones. That is a formidable task.

The central objective of good corporate governance is that businesses behave honestly, equitably, and transparently toward all their stakeholders: owners and minority shareholders; employees, customers, and suppliers; and society at large. Management should not engage in self-serving behavior at the expense of other stakeholders. This includes self-dealing, expropriation of outside shareholders, looting of company assets, expensive management perquisites, management position entrenchment, and shirking. (See Simanjuntak, 2001 for a detailed discussion.) In Indonesia such opportunities abound and have been extensively exploited.

Corporate governance depends a great deal upon incentives and sanctions. There are laws in Indonesia against the various forms of malfeasance by owner-managers, but even now they are not being actively enforced since implementation by the courts is weak and at times corrupt. Owner-managers have disincentives to engage in good governance: reduction of control of their company, reduction of opportunities to exploit outside shareholders, loss of access to governmental favors allocated preferentially through KKN. For them poor corporate governance is a cozy and enriching system. Deep-rooted and pervasive corruption seriously undermines efforts for good corporate governance and indeed good public governance.

There are, nonetheless, strong positive incentive effects. One is corporate reputation, which affects the willingness of outside companies to do business with a company, and potential employees to join it. A far more direct incentive is access to and cost of external finance, essential for all companies. In a country with poor corporate governance, such as Indonesia, the company pay-off for good corporate governance, in terms of reducing the costs of finance, are surely significantly large. Thus the linkage between good corporate governance and the role of an effective financial system is direct and strong.

Mechanisms to achieve good corporate governance are both internal to the firm and external. Procedures initiated by management include accountability reinforced by credible external auditing procedures, disclosure and transparency of corporate performances and basic business decisions, monitoring by independent outside directors, and performance-based incentives, among others. Since companies individually are unlikely to adopt such measures, external pressures and sanctions are usually necessary to force adoption.

Two external mechanisms to ensure good corporate performance are particularly important. The first is the monitoring role of the financial system, whereby banks, bondholders, other creditors, and outside stockholders continuously evaluate company behavior and performance since their own money is at risk. The potential role of the financial system to enhance good governance cannot be overemphasized. This is discussed in more detail in the following section.

The second, stressed by Simanjuntak (2001), is competitive markets. These reduce opportunities for oligopolistic pricing and rent-seeking behavior in both output and input markets. Competition puts pressure on management to be efficient in order not to fail, or, more positively,

to provide all stakeholders adequate returns (dividends, capital gains, interest, wages, bonuses) both absolutely and relative to what others are receiving.

The rules and incentives to achieve good corporate governance apply to all companies, including in Indonesia's case state-owned enterprises, small and medium firms, and the large firms owned by foundations. However, there are important differences among categories of firms for which somewhat different approaches to achieving good corporate governance are required.

4.1 Listed Companies and the Capital Market

It is unrealistic to expect the capital market to play a significant corporate finance role in the near future for all but a few large Indonesia firms but, as the economy develops and grows, it will become an ever-more important source of corporate finance, from both domestic and foreign sources. For that reason it is essential that firms already listed make the transition to good corporate governance now. Even though the number of companies and their share of GDP are relatively small, these firms represent the reality of big business development and growth; they are highly visible signals and symbols of the economy's performance and potential; they have political power, influencing economic and business policy. They are the corporate governance leaders that set the standards others will follow.

Good corporate governance is reflected in company market value. In highly developed capital markets such as those in the United States, corporate governance practices generally meet high standards set collectively by the government regulation authorities, the exchanges, and the markets in digesting information and establishing prices of corporate stocks and bonds. Thus inter-firm variations in American corporate governance practices are small, and accordingly their differential effects on values are small. In economies with poor corporate governance, however, the variance in practices among firms is likely to be high. A recent study of Russian companies demonstrates that firm-specific good corporate governance relative to bad is highly valued, as measured by company stock prices and P/E ratios (Black, 2001). While the literature has not come up with clear evidence on the relationship between corporate governance and performance, a McKinsey and Company survey (2000) of more than two hundred institutional investors asked what sort of premium they would pay for the shares of a company with good corporate governance relative to a poor governance but equal performance for a sample of 22 countries. The premium for share of Indonesian companies with good corporate performance was 27.1%. The average good governance premium was 21.6%, and the range was from 17.9% to 27.6%. A (slightly) higher premium was reported only for Colombia (27.2%) and Venezuela (27.6%). Good corporate governance probably sharply reduces the cost of raising external funds.

Capital markets play a number of important roles for their participants – the corporate issuers of stocks and bonds, the purchasers in the new issue market, and the buyers and sellers in the secondary market. Stock and bond prices are indicators of investor perceptions of company performance and prospects. The better the information on company performance, the more effectively prices serve as a signaling mechanism. The quality of information depends critically on disclosure, and on the other attributes of good corporate performance. It also benefits significantly from evaluations by independent securities analysts and researchers.

Indonesian stock markets grew rapidly between 1989, when only a handful of companies were listed, and the end of 1996 when 253 companies were listed on the Jakarta stock exchange. Many were also listed on the Surabaya exchange, as were some locally-based companies. Business groups controlled by far most of the listed companies, directly and through pyramiding of stock ownership through other firms. Thus, as noted earlier, some 67.3% of the World Bank sample of the 178 major listed firms were owned by families, and another 15.2% were state-owned enterprises that had listed and sold minority stakes. The ratio of their value-added to GDP of the 174 listed firms ranged over time from 3.7% to 7.0% of GDP; by comparison, the ratio for 165 state-owned corporations declined over pre-crisis time from 8.7% to 6.0% (Husnan, p. 10).

The stock market development provided a wonderful opportunity for business groups and other large firms to raise equity capital to complement bank borrowings. Between 1986-1996 the sources of funds for non-financial publicly listed companies was only 17.3% from internal cash flow, 37.9% from borrowing (of which 21.4 percentage points was long-term), essentially nothing from bond issue (-.1%), and a very substantial 23.6% from equity issue. Business groups dominated new issues; between 1989 and 1997, 210 of 257 IPOs were made by group firms, and 96 of 102 rights issues. (Asian Development Bank, Corporate Governance, 2000, p. 50). These equity issues made even more borrowing possible. The debt-equity ratio for listed companies was 253% in 1992 and 229% in 1996, exceeded among the other four crisis countries only by Korea's respective ratios of 325% and 336%.

Foreign investors, predominantly institutions, have had a significant role in the Indonesian stock exchanges. Foreign ownership of publicly-listed companies has been high, 30.2% in 1993 and 25.4% in 1997 (Asian Development Bank, Corporate Governance, 2000, p. 26). In 1999 some 35% of turnover in the Jakarta stock exchange was accounted for by foreigners. Foreign portfolio investors apparently concentrate in a small number of companies that are internationally known and which are among the 25 or so companies covered by PEFINDO, Indonesia's only private credit rating agency and, in some cases, the international rating organizations.

A few major foreign securities companies, with offices in Jakarta or Singapore, have provided coverage of the market and individual firms. However, their efforts remain very limited due to the perceived unattractiveness of investing in Indonesian securities. For example, once the crisis began, US-based Scudder New Asia Fund, a closed end mutual fund, eliminated all Indonesian companies from its portfolio, mainly over concerns about political risks and lack of corporate transparency and disclosure.

As in Korea, Thailand, and other countries, the key policy issue in Indonesia is the protection of outside (or minority) stockholders from the predations of insider owner-managers, not the Berle and Means traditional agency problem of separation of ownership (diversified) and (managerial) control, which typifies the United States and Japan. Business group owners shift profits from publicly listed companies to their non-listed enterprises, typically to the detriment of the outside shareholders of the listed company.

Indonesia's domestic bond market is nascent. In countries where bond markets are meaningful, trading in government bonds typically provides the benchmarks for default-riskless debt of different maturities and thereby the basic term yield curve. Indonesia does not yet have an effective market for government or corporate bonds. Bank Indonesia has used its short-term

central bank paper (SBIs), typically with one-month maturities, as a major instrument of monetary policy, to establish the central bank's short-term interest rate benchmark. From April 2001 the central bank is phasing out its one-month SBIs, instead to use 6-month and 12-month government treasury bills as an instrument of monetary policy, thereby setting benchmarks for a longer term. Banks have been major purchasers of SBIs, given their highly cautionary assessment of lending risks. As of early 2001, that seems to be changing somewhat (Nomura, 2001).

In the government program to recapitalize major banks in 1999, one theoretical option was for the government to have injected cash as capital and to have raised those funds by government bonds sales. However, the bond market was seriously underdeveloped, political and economic uncertainties were great, and the government opted to provide its bonds directly to the banks as capital, with combinations of variable and fixed interest bond yields. However, this approach subjected bank capital to the risk of economic loss if market interest rates rose, as they actually have subsequently. Banks have needed to sell these bonds to obtain funds to engage in their normal lending function. However, if any bonds are sold at a discount all the government bonds in the bank portfolio have to be marked-to market, thereby impairing their already low capital base. For a more detailed discussion, see Pangestu and Manggi (2000).

There are only a small number of rupiah domestic bond issues by a few companies, and their secondary markets are thin. Most issues were possible because of evaluations by PEFINDO. In 1997 the amount of corporate bonds outstanding, both rupiah and foreign currency, was only 1.5% of GDP. This compared to ratios of 60.2% for bank loans and 21.7% stock market total capitalization (ADB, Corporate Governance, 2000, p. 47).

Large Indonesian companies in the 1990s were much more active in issuing foreign currency denominated bonds and related forms of debt than in tapping domestic sources. At the end of 1997 Indonesian companies had issued about \$7 billion of foreign currency bonds (not all in US dollars). By the end of 1999, \$5.777 billion (74%) was in default; there were no additional defaults in 2000. (JP Morgan Asian Financial Markets (2000).) However, in spring 2001 the core company of the Sindar Mas group, Asia Pulp and Paper, defaulted on its very large foreign bond issues and loans. Defaulted bonds comprise a huge debt overhang for the borrowing corporations, especially because the rupiah has depreciated 70% or so since they were issued. The much larger private foreign debt problem is foreign currency loans, supplier credits, and other foreign claims on Indonesian companies and banks. According to Moody's (2000), only about \$5 billion has been restructured, with an estimated \$70 billion still under negotiation.

One reason for the underdeveloped corporate bond market in Indonesia is that standard institutional investors, such as insurance companies and pension funds, may be numerous but their aggregate assets are still small, so they are not major players in the Indonesian financial system. They invest most of their assets in time deposits; any direct finance to corporations is mainly in the form of loans rather than bond purchases. While there are 62 life insurance companies and 109 non-life insurance companies, market concentration is high. Two of the top five life insurance companies are state-owned, and the other three are joint ventures; their market share (based on gross premiums) in 1998 was 71.9%. The non-life insurance industry is considerably less concentrated; the 1998 gross premium share of the top 5 was 41.3% (Alder, 2000). The scandalous Manulife court case beginning in 2000, whereby the Canadian joint venture partner

was exposed to third-party extortion in attempting to buy up its Indonesian partner, is one of several recent cases which have made foreign direct investment in Indonesia far less attractive.

4.2 Agency Problems and Corporate Governance

To emphasize once again, listed companies in Indonesia face two major agency problems: controlling owners and their managers versus minority shareholders; and membership in an owner-controlled group. Almost all Indonesian listed companies are controlled by a single individual or family, as in Korea, Thailand and many other developing countries, but unlike the developed economies, including Japan. This often is achieved through complex cross-shareholding and pyramiding of companies. In any case, the owners appoint and control the two-tiered Board of Commissioners and Board of Directors, and top management, and are involved in all key business decisions (Simanjuntak, 2001 and Husnan, 1999).

The key agency problem is between the controlling owner-management and the outside shareholders. The major corporate governance issue is to protect the outside (usually, even collectively, minority) shareholders from exploitation by the owner-managers. Exploitation of outside shareholders of listed companies is not unknown in Europe, or even the United States. It is pervasive throughout Asia (see Claessens et al 1999a and 1999b).

The proposed Code for Good Corporate Governance represents an Indonesian governmental response to the IMF requirements under the Letters of Intent (LOI) to achieve good corporate governance. As often seems to be the case in Indonesia, the proposed mechanisms and rules of behavior are reasonable and good, but the process of implementation is opaque and the likelihood of effective implementation low.

Apparently the Commission drafting the Code for Good Corporate Governance visualizes its being voluntarily adopted by companies in their self-interest. The Commission is considering regulatory incentives and punishments to be imposed at the sectoral level by different relevant government ministries, with no single set of objectives. The real purpose and intent of this approach are not obvious.

Ultimately, the key to reform is to restructure incentives for owners and managers so as to be compatible with good corporate governance. One set of incentives is in the terms of access to external finance, as already stressed. Probably the strongest and most consistent pressure for better corporate governance in practice has come more from foreign institutional equity investors and providers of loans. If Indonesian firms want to obtain foreign financing, they have to have good information systems and corporate governance structures in place. Ernst & Young in Jakarta is developing a rating system for evaluating the corporate governance practices of large Indonesian firms in order to enhance the well-rated firms' international credibility and credit ratings, and thereby reduce the cost of foreign borrowing; however, how conflict of interest issues in its role also as an accounting and auditing will be handled is not clear.

For listed companies, good corporate governance rules can be (and apparently to some extent are) embodied in the rules and regulations for listing on the stock exchange. Unfortunately, forbearance – the willingness to delay decisions regarding insolvent or deeply distressed listed

companies – describes the behavior of the stock exchanges in implementing their own rules for delisting. Again, a key problem is implementation. The Indonesian stock exchanges are not strong, effective self-regulating institutions, and government oversight in practice is not strong.

4.3 Corporate Governance of Large Unlisted Companies

Private, tightly held companies do not have the same kinds of agency problems among equity owners that listed companies do. Typically, all the shareholders are insiders – family members or persons who know each other very well. However, that does not mean that good corporate governance rules and procedures are not relevant or needed. Large companies can have a substantial wider impact. In a society where they may be tempted to engage in corrupt practices or develop political influence, their behavior and performance should be subject to some degree of public disclosure and transparency. No companies should be allowed to engage in illegal behavior. As a practical matter, in order to obtain needed external funding from arm's-length sources, even private companies must provide disclosure of financial circumstances, business strategy, and other features of good corporate governance to their creditors. In this way, finance forces better corporate governance on private firms that require external funding.

5. The Role of Banks in Corporate Governance

Banks are engaged in the business of financial intermediation between savers and investors. They pool the risks, information costs, and administrative costs of lending, and provide a presumably safe depository for savers. Banks usually are substantially leveraged, with low capital ratios relative to risky assets. Bank safety and depositor safety are key, interrelated concerns; and effective, comprehensive risk management, a relatively new analytical concept, is essential.

Banks are different from other financial institutions, and indeed from all other sectors, due to the possibility of bank system instability leading to credit contraction for all other sectors. Difficulties at one bank can lead to sudden deposit withdrawals, and this can spread quickly throughout the banking system if depositors panic, resulting in financial contagion, systemic illiquidity and instability. It should be noted that while banks runs are routinely called "panics", they should be viewed as investor flights to safety where information is poor and institutions are suspect.

The basic contribution of banks to good corporate governance is through their monitoring function of their clients: evaluation of the creditworthiness of new projects; monitoring of ongoing performance of the project and the company; and assisting in the restructuring of client firms in distress. Effective monitoring requires that the bank be independent of the borrower, and also of government pressures, so as to make objective lending decisions. It must have sufficient access to information about the borrower's capabilities and performance; collateral alone is not enough. And the bank itself must engage in good corporate governance practices, including disclosure rules and transparency.

5.1 The Lending Decision

The basic problem for any bank is to determine the creditworthiness of its borrowers, starting with whether to lend at all. Having decided to lend, the question then is under what terms, including the applicable risk premium.

Corporate finance theory stresses the asymmetric information problem, in which the borrower is presumed to know more about his business situation than the potential lender. Important in practice is the reality the borrowers often do not know much better than the lenders what their true position is, and of course no one knows exactly what the future will bring. Even when borrowers have the best of intentions, both lender and borrower can be at risk because of poor accounting and information standards. Further, changing circumstances can turn good loans to good companies into problem loans to distressed companies.

Banks have various mechanisms to protect themselves from the various sorts of risks they face. One is to require specific collateral against loans. However, the requirement of collateral is effective only where markets exist for the collateralized assets, the leverage is conservative, and the distressed borrower is an isolated case. When, as the experience in Indonesia, Thailand, Korea, and Japan have demonstrated dramatically, the crisis is systemic, not only does the real value of the collateral decrease sharply, but it cannot even be sold at that highly-discounted price, as markets have dried up. Difficulties are exacerbated when the legal and institutionalized mechanisms for banks to obtain and sell the collateral are weak. Such problems are widespread, as the current experiences of Indonesia, South Korea, Thailand, and even Japan (Hoshi and Patrick 2000) well demonstrate.

There is a critical danger in banks relying on collateral rather than making the effort to obtain specific information about a company, both when the loan is made and during its term (monitoring). In other words, bank dependence on collateral arguably has significantly retarded its development of analytical skills and emphasis on cash flow. This has been a problem in most countries. Banks also may lend more to a company than otherwise would be the case. Leveraging up against rising asset prices during Japan's 1980s bubble has greatly exacerbated Japan's problems since those prices collapsed.

A second mechanism banks use is to require third-party guarantees. Again, this provides adequate protection only where the default is idiosyncratic rather than systemic, so that the guarantor's assets are not caught up in the same crisis that the company is facing. Such guarantees were widespread in Indonesian banking, so some of the assets IBRA obtained through bank failures and reorganization are actually quite good.

5.2 Relationship Banking

There is no substitute for banks acquiring detailed company-specific information about their borrowers, their industries, and their markets, then engaging in careful analysis. As part of this, a borrower must provide its bank with comprehensive information about its conditions, business strategy, and prospects in exchange for building a long-term, repeat business, financing arrangement. This is the essence of relationship banking, which in practice is a dominant feature of banking in all countries.

Relationship banking, especially among large firms, is epitomized by the Japanese main bank system in its high growth era heyday (Aoki and Patrick 1994). Effective relationship banking requires both that banks have quite detailed access to company private information and that they use that information for careful credit analysis and effective monitoring of the borrowing company's performance, behavior, and prospects. A healthy relationship means that each benefits from the success of the other in the longer as well as short run.

The greatest danger in relationship banking is that the bank is not independent and autonomous, but rather is a captive, typically of a business group which controls it. Accordingly, the bank lends disproportionately to businesses controlled by its owner, thereby reducing loan portfolio diversification and otherwise taking excessive risk since it does not apply objective credit analysis.

In the early stages of banking development in Japan, captive banks were termed "organ banks"; they were the financing organ of the industrialists that owned them. Interestingly, this term was not used to describe the emerging zaibatsu and their banks, as zaibatsu firms did not rely substantially on loans from their banks until the late 1930s. Without high degrees of disclosure and transparency, it is very difficult for regulators to prevent excessive lending to affiliated companies, as the cases of Mexico from the late 1980s and Chile in the early 1980s and certainly pre-crisis Indonesia demonstrate.

5.3 Banks as Captives of the State

Banks can be direct or indirect captives of the state. State-owned banks dominated Indonesia's banking system until the financial liberalization of the late 1980s and early 1990s, continued to have a major market share, and once again are dominant because so many major banks have been taken over by IBRA and recapitalized. State bank performance and levels of corruption was even worse than for private banks; venal politicians and bureaucrats dominated their policy decisions and credit allocations. (For useful comprehensive discussion and analysis of Indonesia's pre-crisis finance and banking system, see McLeod (1994) and Cole and Slade (1996).)

Ownership is not the only way governments control banks and bank lending. Korea has been an outstanding case of government control. The Korean government prevented business group ownership and control of banks, but took the other extreme of itself exercising heavy and often direct controls over bank lending, specifying not only industries but even firms to which banks had to make "policy loans". This was a major source of chaebol development. Equally

important, until the late 1990s crisis, the government in effect appointed the presidents of the large banks that dominated the banking system, and engaged in all sorts of intrusive controls. Bank management may have been independent of shareholders, but it was not independent of government. This resulted in inefficient credit allocation and in stifling the development of managerial capabilities, as well as the critical functions of credit analysis and risk management.

If banks are controlled neither by majority owners nor by the state, then management usually has effective control. If bank management behaves so as to maximize profits, it will engage in effective monitoring of its borrowers, and its loans will be allocated and priced efficiently. This indeed is the basic assumption of the efficient, competitive market model. So long as profit maximization is the dominant objective of the bank and its management, then whether controlled by a majority shareholder or having widely distributed shareholding should not matter. In reality, of course, they matter a great deal, because of a range of agency problems. Accordingly, disclosure, transparency and other good corporate governance practices are essential to prevent bank management from engaging in various kinds of misbehavior.

5.4 The Monitoring of Banks and Their Corporate Governance

If banks are the major monitors of company creditworthiness, behavior and performance, then who monitors them? There are three mutually reinforcing mechanisms: internal corporate governance; capital market monitoring and signaling; and governmental prudential regulation and supervision of the banks.

Banks and other financial institutions must be subject to the same good governance norms, rules, and practices applicable to industrial corporations: disclosure, transparency, (honest) outside auditing, a board of directors and management responsible to all stockholders, and so on. But good bank governance goes beyond that. There also must be rules to ensure that banks do not engage in excessive risk-taking, excessive concentration of loans to connected companies, or loans allocated on the basis of KKN.

An effectively functioning capital market serves as a monitor of banks that have listed shares, which means essentially all large private (non-state) banks. Stock market prices signal investor evaluations of bank performance and prospects. Credit rating agencies and bank securities analysts, particularly those working for foreign securities companies, have an important role in evaluating the safety of banks and their debt instruments. Good credit ratings make possible a lower cost of funds. However, it is naive to believe that financial markets are sufficiently self-regulating or that foreign or domestic investors are particularly good at assessing risk, particularly in developing countries and certainly not in Indonesia, now or in the foreseeable future.

The safety of the banking system is a public good. Effective prudential regulatory supervision is essential to prevent systemic distress – bank runs, financial panic, flights to financial safety, the drying up of credit for business. In practice prudential regulation and supervision are on a bank-by-bank basis. The first defense against systemic failure is dealing with possible individual bank failure. This means weak banks should be allowed (or forced) to exit (end operations). A policy that no bank should fail – the Japanese policy for some 40 years until the

early 1990s – is very costly and even dangerous because of the regulatory forbearance it engenders; such a policy is incompatible with a market-based competitive financial system (Hoshi and Patrick 2000).

The best way to ensure bank safety and satisfactory performance is through a combination of good corporate governance, effective prudential supervision by governmental regulatory authorities, relatively high risk-adjusted capital adequacy ratios, and the maintenance of market competition. The Indonesian banking system fails to meet any of these criteria.

5.5 Deposit Insurance

An essential driver of banking system safety is depositor protection. It is depositor fear of loss of their deposits that causes bank runs. And bank runs, if they cannot be contained, create financial contagion and systemic crises because banks are inevitably highly leveraged. Deposit insurance and government guarantees superficially appear to be a reasonable way to provide deposit safety, and hence limit the negative external consequences of specific bank failure. However, they also create potentially severe problems of moral hazard. A bank, especially when in a weakened condition, is tempted to take on excessive risks while charging higher interest rates in order to gain profits. If it is fortunate, it wins and stockholders benefit. If it loses, then the loss is absorbed by the deposit insurance system, the government, and the taxpayers. When a bank has zero (or negative) net worth, its owners and managers have nothing to lose by making risky loans.

A clear distinction must be made between small depositors (typically, relatively poor individuals and small enterprises) and larger depositors (wealthy individuals, larger businesses, and other institutions). Small depositors generally have few alternatives to bank deposits as a place to put what few financial assets they have. They should be protected, but for reasons of social justice. This means the amount covered per person should be small. While sufficient to cover a large number of (small) depositors, the aggregate amount of deposit coverage should be only a relatively small proportion of total deposits.

Deposit insurance has been used to protect small banks as well as small depositors. One rationale has been that small banks are less able to diversify geographic and other risks than large ones. The introduction of deposit insurance in the United States in the early 1930s was a political decision to protect small banks (Economides, Hubbard and Palia, 1996). The Japanese Ministry of Finance decision in 1995 to extend insurance coverage to all deposits was to help all banks, and especially small ones; and the decision to delay the return to the 10 million yen deposit coverage limit from 2001 to 2002 was clearly motivated by political pressure to protect small banking institutions.

In Indonesia, as elsewhere, an overwhelming proportion of deposits are held by individuals and in small amounts. It was estimated in early 1999 that a deposit insurance maximum of 10 million rupiah (slightly less than twice per capita GDP) would cover 93% of the deposit accounts, while being only 23% of the total amount of bank deposits.

Why not provide larger amounts of deposit insurance coverage? It is because most banking crises provide clear evidence that the moral hazard problems of bank risk-taking behavior are severe. When larger depositors have their funds at risk, they have a greater incentive to

ascertain (monitor) the safety of the banks, thereby putting greater pressure on banks to engage in careful risk management, transparency, and good corporate governance. Indeed, this monitoring function is why most regulatory authorities require tier-two capital as a supplement to tier-one (direct equity) capital, often by subordinated debt sold to other, independent financial institutions (such as insurance companies, pension funds, and asset management companies) that thereby have a direct interest in monitoring the bank's performance and safety.

Once a banking crisis erupts, the monetary authorities must prevent it from becoming even worse. The political reality in virtually all countries with a banking crisis is that governments intervene to temporarily guarantee all deposits, while their regulatory authorities sort out the insolvent banks from the illiquid banks, and decide how to deal with the insolvency cases (liquidation, merger into stronger institutions, recapitalization). This has been the case in their respective banking crises not only in Indonesia, but also in Thailand, Korea, and Japan. However, to justify this guarantee, bank restructuring and recapitalization should proceed quickly, and the unlimited nature of the deposit guarantee terminated as soon as possible. That takes great political will, as the ongoing experiences of these countries continue to demonstrate.

Because of significant moral hazard problems, deposit insurance has only a limited role as a policy instrument in promoting banking system development. In particular, it works well only when there also is effective regulatory supervision.

6. Indonesia's Banking Mess

The 1997-98 collapse of Indonesia's banking system and its adverse effects on the economy have been by far the most severe among the Asian crisis countries, and is one of the worst implodings of any nation's financial system in the past 50 years. The immediate cause emanated from the huge foreign exchange losses banks and their large corporate borrowers incurred when the rupiah depreciated in the last half of 1997. The depreciation, an 86% decline before bouncing back somewhat, was far more than for any other Asian currency. The crisis exposed wide-ranging, deep weaknesses: bank mismanagement, political interference (including support for bank owners close to the Suharto family and the government), illegal, hugely excessive lending to companies in the same business group, and a host of other KKN activities. Bank sector capital was wiped out. Although some banks (mostly small) had positive net worth, most had large negative net worth.

One indicator of how bad the collapse was is the set of rules the regulatory authorities used in deciding which banks to close and which to consider saving. Only banks with a risk-adjusted capital asset ratio (CAR) of worse than minus 25% were to be closed. Banks with a CAR between minus 25% and plus 4% were deemed worthy of consideration for government rescue. The few banks with a CAR of 4% or more were deemed sound. Most large banks, almost all of which were insolvent, were bailed out.

The Suharto government's mishandling of the financial crisis was scandalous, epitomized and symbolized by the Bank Bali case and the huge amount of Bank Indonesia loans (144.5 trillion rupiah, \$17.3 billion) made by inappropriate, probably illegal, procedures to a politically selected group of the banks at the height of the crisis. This was revealed most fully in the Supreme

Audit Agency (BPK) report released in August 2000 (Nikkei Weekly, “Credit scandal plagues central bank”, 28 Aug 2000).

Pangestu and Habir (2001) provide a comprehensive analysis of these matters, and the efforts since the crisis by IBRA, the Ministry of Finance, and the central bank, Bank Indonesia, to recreate the banking system as sound, effective, and efficient. Their analysis provides evidence for several themes stressed here. As they point out, 8 of the 10 largest banks were members of diversified business groups, about half of bank lending was to companies in its own group and, amazingly, loans to such groups were on the order of 20 times the legal lending limits.

In addition, a useful summary description of the main restructuring stages appears in Lindgren et al (1999); an excellent discussion and analysis of bank closings and related policies since November 1997 is Enoch (2000). Ongoing updates are provided quarterly by the World Bank's *East Asian Quarterly Brief* and annually by Moody's Investors Service (1999, 2000). Other quite useful analyses include Fane (2000), Aten (2000), Nasution (1999), McLeod (1999a and 1999b), Hill (1999), and Cole and Slade (1998).

The government completed its bank recapitalization program in October 2000 with the recapitalization of three state banks and three major private banks. (ADB, [Asia Recovery Report 2001](#)). The government Bank Recapitalization Bond restructuring at about the same time made it possible for banks to make liquid some of their capital to lend to corporate clients. Banks began lending again in 2000. Despite recommending an Underweight stance for the banking sector compared to other Indonesian stocks, Nomura (2001, p. 98) lists two banks as Outperform, Bank Panin and Bank Central Asia, which are described as “relatively liquid, clean and inexpensive.”

6.1 The Imperative of Reform

Establishing a strong, efficient, honest private banking system must be an ongoing top priority, both for the financial system and more broadly for effective corporate governance. The core will be a relatively small number of relatively large banks, those that have received government capital, those that IBRA is selling off, and those state banks that are being reformed and (in some cases) privatized. Smaller banks, important locally as sources of SME finance, must also be incorporated fully into the reform process.

Policymakers, and bankers re-establishing Indonesian banks face five major tasks: determining and achieving a good bank ownership structure; replenishing capital essentially wiped out by the 1997-99 banking and economic crisis; learning how to determine the creditworthiness of borrowers; learning how to manage the overall risk associated with their assets and liabilities; and establishing and effectively implementing a sound system of prudential oversight and supervision.

Creating a viable banking system involves a series of interrelated issues. The most important are to ensure that each bank is adequately capitalized; that there is honest and effective prudential supervision, and that each bank is an independent, autonomous organization rather than a captive of any business group. Banks cannot be expected to do all these things voluntarily. The incentive structure does not work that way in Indonesia.

6.2 Ownership and Control of Banks

Following the crisis-induced banking system collapse, IBRA take-over of private banks, and government recapitalization of both private and state banks, the government now owns 72% of Indonesia's bank assets (Kawai, 2001). This has, at least for now, broken the link between family-controlled business groups and the large banks. This provides an opportunity to create a new ownership structure which promotes independent and objective allocation of bank credit by bank management, without being the captives of their major borrowers.

There are three models of bank ownership and control: state ownership (or control); widely dispersed share ownership with considerable management independence and autonomy; and ownership and control by a single dominant unit (a family or a foreign financial institution).

Indonesia's state banks have behaved and performed even worse than the private banks; they have been more subject to political interference in credit allocation, internal management bureaucratic inefficiencies, and the tribulations of KKN. From the late 1980s, the Indonesian authorities pursue a policy of reducing the hitherto overwhelming role of state banks by making possible, and promoting, the development of private sector banks. Despite the crisis-induced renewed government ownership of banks (the state banks and IBRA-controlled banks), the ongoing policy is, appropriately, to privatize those banks as rapidly as circumstances make feasible. However, as Pangestu and Habir demonstrate, those circumstances do not appear to be propitious now or in the near-term future.

The American system of stock dispersed ownership of banks is effective mainly because good corporate governance mechanisms are in place to provide shareholder oversight and, concomitantly, bank management commitment to maximization of profits and shareholder value. In contrast, in Japan's dispersed ownership system, management performance has been poor because of weak corporate governance and the cross-shareholding relationships benefiting the managements both of borrowing companies and the banks. Unless and until good corporate governance and effective financial market competition are in place in Indonesia, dispersed stock ownership of banks would probably result in an ineffectively autonomous bank management in most instances. Moreover, the government and its monetary authorities are not likely to be a good source of performance-oriented discipline on bank management. Indeed the Korean experience suggests just the opposite: the government interjected its own policies, requiring so-called policy loans by the banks, to achieve government objectives. In Indonesia, a system of government control of private banks would be as bad as direct government ownership of state banks. And in a system of dispersed ownership, unless and until bank management incentives are aligned with shareholders, it is unlikely that stock price and other signals through the capital market will have a major impact on management behavior and performance.

Both the logic and reality are that for the foreseeable future, private sector Indonesian banks will be controlled by one owner who has control, directly or indirectly. There are three options: foreign ownership; independent domestic ownership; or ownership by an individual (or family) as part of his business group of companies. Indonesian policymakers have been sending very mixed signals regarding large, strategic direct investment in Indonesian banks by foreign

financial institutions. On the one hand they are virtually the only potential buyers as IBRA attempts to sell off its stakes in the banks it recapitalized. Moreover, foreign banking institutions bring in and implement better banking and management practices – credit evaluation and all that. On the other hand there is great reluctance, particularly in the legislature and by bank employees, to allow significant foreign ownership and control; xenophobia appears strong. While a few foreign banks may come to play a prominent role in Indonesia's banking system, it is very unlikely that foreign ownership will ever become dominant. Indonesia, like virtually all countries, will continue to maintain domestic ownership and control of its banking system.

What are the prospects for independent banks based on a domestic dominant owner, with arms-length lending relationships with borrowers? I think they are very low. First of all, the previous owners are still wealthy and are thus able to re-purchase their banks and have the ability to assess the bank's current value. While precluded by policy from re-purchasing now, in the absence of other viable purchasers over time they may well regain ownership and control. But suppose new Indonesia investors emerge as purchasers of the banks? Will they manage the banks as independent, arms-length lenders to business? I doubt it. Those wealthy enough to buy a bank and to want to own one will already be owners of industrial companies; that is, they will already be owners of business groups. While the specific families that previously owned banks as part of their business group may decline dramatically in power and importance the system of family-owned business groups will persist for the foreseeable future in Indonesia. If the most likely ownership structure for Indonesian banks is once again to be family-owned, and as part of a business group, then prudential regulation and effective supervision will be more important than ever.

6.3 The Importance of Adequate Capitalization

The adequate capitalization of Indonesian banks has two major components: the remaining bad or doubtful loans must be fully provisioned against, and the policy target of a capital adequacy ratio (CAR) of 8% by the end of 2001 must be achieved. In practice it is unlikely that resolving both CAR and NPL (non-performing loan) problems will be reduced soon, even though they remain the key to establishing a sound banking system. The obstacles to obtaining additional equity (or even Tier two) capital from private sources, domestic or foreign, are too great. This implies additional injections of government funds will be necessary, but this is an investment the government thus far has been unwilling to make. In the near term, Bank Indonesia has touted the importance and indeed the ability of banks to achieve the 8% CAR target, while allowing considerable slippage on the 5% NPL target. In reality the CAR measure has little meaning if the amount of unprovisioned NPLs remain large, as apparently is the case for a number of Indonesian banks. It should be noted that injection of government funds as capital is an investment, not a give-away of taxpayer monies, since the government bonds used as bank capital will eventually be repaid by the banks as they become profitable and strong. More fundamentally it is government investment in a strong and stable banking system, essential for sustained growth over the longer run. At the same time, even an 8% CAR minimum is probably too low for banking stability and strength in a well-functioning, competitive banking system; but that is a much longer-run problem.

Bank safety is buttressed by the continuation of the government's blanket guarantee of all deposits, instituted at the height of the crisis in January 1998. The guarantee should be terminated

soon, and a return made to a much smaller, more limited deposit insurance program. Limited deposit insurance coverage could be considered as a creative way to provide incentives for depositors to move deposits to safer banks.

Depositor safety in the long-run should be founded on the bank safety that is engendered by a high CAR, effective regulatory supervision, and good bank performance. The sole function of deposit insurance should be to reassure small depositors, and then primarily for reasons of social justice.

6.3 Management: Credit Evaluation and Risk Management

Bank profitability is the key to bank success and sufficient capital adequacy. While loans are abnormally low now, over time loan demand can be expected to grow. Indonesian bank interest rate spreads between loans and deposits have typically been wide, reflecting both high investment demand and high transactions costs. However, loans were not made on the basis of careful credit analysis of cash flow, business prospects, or even adequate appraisal of loan collateral. Frequently lending was based on business relationships, particularly with other members of the group of companies also owned by the bank owner. A reasonable degree of such lending is to be expected because of special information access and can be desirable if borrowers are sound. However, the problems have been that loan amounts were shockingly excessive, on unwarranted preferential terms, and without adequate credit analysis or collateral. Both profitability and safety are dependent on improvement in Indonesian bank management thinking and practices. Many large Indonesian banks are engaged in intensive systems restructuring, especially in risk management (Moody's 2000). Credit analysis, information gathering, and other inputs to effective bank staff monitoring of client companies continue to need to be strengthened.

6.4 The Importance of Supervision

An essential component of the banking and financial systems is a strong, effective prudential supervisory system, combining laws and institutions with the human skills of regulators to ensure that banks are strong, honest, and performing well. Banking regulations must be enforceable and enforced. Reform of the courts to ensure honest legal decisions and to prevent inordinate delays in policy implementation is necessary, but how quickly and effectively court reform comes about is an ongoing concern. Clearly the regulatory and supervisory institutional structure needs to continue to be strengthened and upgraded.

It is not clear whether setting up a new agency and ending the regulatory role of Bank Indonesia is the correct decision. Essentially the choice depends upon which institution can exercise the most power, be the most independent of KKN pressures, and be the most effective.

6.5 Commercial Banking System Structure

There are various ways to analyze the structure of the Indonesian banking system. One is by type of ownership: state banks, private sector banks, foreign (joint venture) banks. Private sector banks can be subdivided into three categories: those (relatively small) banks deemed strong

enough (category A, meeting the 4% CAR requirement) not to require injection of government capital; the seven large banks recapitalized with government bonds; and the five large and important banks taken over by IBRA, which plans to sell them off (Pangestu and Habir, 2001).

Another approach is by size and type of business a bank is allowed to pursue. There are 15 large banks, 4 state and 11 private sector. They are allowed to engage in a wide range of foreign exchange transactions as well as other banking services, as are another 50 mid-sized private sector banks and the foreign banks. There are another 69 smaller banks only allowed to do domestic banking business; 43 private sector banks and 26 state banks including the regional development banks. Generally speaking these banks did not suffer the huge losses generated by the rupiah devaluation that all the large banks suffered.

A third category is bank specialization by size and type of borrower. Large Indonesian companies typically borrow from large Indonesian banks as well as from foreign banks and capital markets. Indeed most of the banking system loans have been to large corporations. Accordingly it is not surprising that much of the policy focus has been on large banks and their large corporate clients. Privately owned medium-sized and smaller companies (SMEs) are relatively less able to borrow from banks and rely substantially on informal sources of external finance as well as retained earnings and new equity provided by their owners. Microfinance – very small scale, predominantly rural finance – is provided by a combination of extensive and fairly well-developed state and private rural savings banks, credit cooperatives and agencies, moneylenders, rotating credit groups, and the like (Bank Indonesia and GT2, the Foundation for Development Cooperatives).

The desired structure should acknowledge and strengthen the existing structure which differentiates among domestic banks (state and private sector) allowed to provide a wide range of banking services including foreign exchange; foreign banks; smaller banks providing only domestic financial services to large and SMEs borrowers; and special microfinance institutions.

The focus here is on large banks and large corporations. Indonesia has a size mismatch: its largest industrial corporations, such as Indofoods, have normal financing needs for operation funds, much less long-term finance, far in excess of the prudent lending capabilities of even any of the largest banks. Assuming the maximum legal loan limits will not be breached in the future (probably a heroic assumption), then either there will have to be further bank consolidation or bank syndicates will have to be formed to lend to Indonesia's largest companies.

The financing of SMEs will be an ongoing political as well as economic issue. As the Indonesia's banking system develops and grows as a mobilizer of savings, in time banks will gradually expand their capacity and willingness to lend to more SMEs, a natural and inevitable consequence of developing strong, competitive financial and banking systems. While beyond the scope of this study, it is worth noticing the government has underway a range of programs for SMEs and micro finance, supported by the Japanese and German foreign aid agencies (Urata, Bank Indonesia and GT2).

7. IBRA and Asset Sales

The government now owns or controls an overwhelming proportion of Indonesia's corporate and financial assets. The Indonesian Bank Restructuring Agency (IBRA) holds some 40% of the country's corporate assets. State banks (which were in even worse shape than private banks) and state-owned enterprises own another 40%. The stated value of assets taken over by IBRA is \$57.8 billion, some 57% of GDP. Excluding Japan, only in Korea was the amount taken over by the government's asset management authority larger in amount (\$84 billion), though much smaller as a percentage of GDP (11%). (For a more detailed discussion and analysis, see Pangestu and Habir (2001)).

IBRA has two major, interrelated responsibilities: to sell the corporate and bank assets it acquired when large banks and large businesses collapsed; and to reinvent the banking system. It has made more progress in the latter. IBRA's program to sell assets is vital and, in the longer-run, so too is the privatization of many state-owned industrial and banking enterprises. How this is done is important: privatizations that merely transfer state wealth to selected individuals or state monopolies to private monopolies are certainly not desirable. It appears the privatization of state-owned industrial enterprises will continue to proceed slowly for a variety of reasons: political unwillingness to implement privatization policies; entrenched management reluctance, even intransigence; lack of credible buyers; and unattractive privatization terms.

IBRA sales are a slow and difficult process, particularly given the realities of Indonesia's political economy, and the challenges of creating the banking system anew. IBRA published a five-year strategic plan in 1999 (IBRA 1999). The real problems are not so much in the plan as in its effective, speedy and smooth implementation – Indonesia's ubiquitous fundamental policy problem. (For a useful brief summary of IBRA's programs, see the prospectus for its offering of Bank Central Asia shares (Danareksa Securities and Bahana Securities May 2000).) As of the end of 2000 IBRA had sold only 7% of its assets, far below Korea (48%), Malaysia (61%) and Thailand (70%).

IBRA symbolizes and indeed epitomizes the difficulties of Indonesian economic reform. The sales process has been essentially political, with intense infighting behind the scenes between the still powerful former owner debtors, members of the Wahid government, potential purchasers, and the legislature as the many political parties build war chests for the next election. The process is also fundamentally opaque, only surfacing from time to time when IBRA attempts to sell a major asset, and is complicated by an ineffective and corrupt bankruptcy system.

Even without political interference, IBRA's difficulties are great. It is important to sell assets quickly in order to generate budget revenues and to reduce further deterioration of underlying asset values, but pricing is a serious problem both because asset valuation is difficult and because pressure to sell reduces prices further. The number of potential buyers with sufficient assets and credit are relatively low.

Financially, the best local buyers are politically the least attractive: the very Chinese Indonesians whose capital flight exacerbated the crisis. Then there are foreign investors. IBRA's chairman in spring 2000 articulated a strategy based on his perception of the evolution of demand: selling first to Chinese Indonesians, then to foreign turn-around funds, and finally to foreign long-term strategic investors, who will feel more confident once Chinese Indonesian entrepreneurial

business leaders return. However, chairmanship of IBRA has been a position of high turnover, reflecting the deep political tensions, so policies always appear to be in flux. Foreign investors are an obvious possibility since they have funds, technology, and management skills; however, problems facing several recent major cases of sales (such as Mexican Cement in Semen Gresik and Malaysia's Kumpulan Guthrie in Salim's plantation) send negative signals to potential foreign investors. It is unclear whether the old system of cronyism, albeit perhaps with some new players, is being reestablished.

The reality is that for the foreseeable future owner-managers will control virtually all large private-sector companies, both listed and unlisted and including financial institutions. Their self-interests remain contrary to the rules and mechanisms of good corporate governance.

8. Conclusion

Good governance – institutions, mechanisms and especially implementation – in its broadest terms of the political, economic and legal systems and their institutions is essential for the successful long-term development of Indonesia. Moving to good governance from its deeply flawed present situation will inevitably be a long-run, ongoing, perhaps never-ending process, in which both the substance and the sequencing of policies will be important.

The combination of Indonesian economic and political crises of the past few years, and the shift from an increasingly corrupt authoritarian regime to an extraordinarily pluralist nascent democracy provide a special opportunity, and challenge, for policymakers and indeed for Indonesian society. It is coming to be recognized in Indonesia that government failure has been far worse than market failure. Government-based allocation of resources has been less efficient and more corrupt. While the weaknesses and deficiencies of the Wahid government did little to solve these problems, the hope is that a new technocrat economic team under new President Megawati will address these issues more positively and strongly.

Corporate governance is an important subset of the broader concept of governance, particularly because it includes state-owned enterprises and banks as well as private sector corporations. As in other developing economies, Indonesian businesses must depend significantly on sources of external finance, whether they be companies listed on the stock exchange or SMEs. When consideration of good corporate governance is limited to the 250 or so companies listed on the stock exchange, as Simanjuntak (2001) notes corporate governance is not particularly high on the priority list of issues confronting Indonesia. Even so, at this critical point in time the establishment and especially the implementation of good corporate governance rules and norms will have a broader effect. They establish the standard and model for behavior of unlisted companies, large and small, and especially for state-owned enterprises. They will apply directly to the additional firms that go public as the Indonesian economy develops and grows in the long run. And good corporate governance practices will be extremely important to attract foreign investment once again, for direct investment in joint ventures, institutional portfolio investment in Indonesian equities, and foreign bank loans to Indonesian companies.

It is inevitable that banks will continue to be the primary source of external finance for all large Indonesian businesses, private and state-owned. As such banks, better than any other

institutions or government agencies for the foreseeable future, will be the main mechanisms, aside from owners themselves, to monitor their business clients and to provide incentives for their enhanced productivity and performance, and to inhibit looting, in whatever form, by their owner-managers.

Indonesia's banking and finance are very far from having what are considered the characteristics and functions of a strong, stable, effective, efficient, competitive system. The financial system is not able to engage in adequate monitoring of its borrowers, and does not incorporate the basic elements of a good corporate governance system. Fortunately, the policies for banking and financial reform are reasonable. Unfortunately, they face powerful vested interest group pressures to compromise their implementation, which thus has been slow and halting.

Indonesia has shown it is good at grasping opportunities. But it must move from seizing those that have hindered development and enriched a few to embracing those with broader benefits. While path dependency inevitably shapes outcomes, as Simanjuntak well states (2001, p. 58), "the future is too important to be left hostage to history."

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