Indonesian policy on non-residents' participation in the money market: the restriction of rupiah transactions by non-residents and foreign currency credit offered by banks to non-residents

Hartadi A Sarwono[1]

Background

The financial crisis which began in the second half of 1997 devastated Indonesia's banking sector and resulted in a prolonged economic downturn that continues to affect the economy today. The source of the crisis can be traced to the acceleration of Indonesia's economic integration into the global financial market, without the corresponding development of the required institutions to ensure the smooth running of the financial and corporate sectors. Among other liberalisations, the Government allowed the rupiah to be freely convertible for capital account transactions as well as current account transactions and at the same time permitted the internationalisation of the currency.[2] Indonesia allowed the development of an active offshore market in the rupiah. The rupiah became a commodity tradable in the international market. The international use of the rupiah for export and import payments, however, was not significant. Export and import invoices were mostly denominated in major world currencies, including the US dollar and Japanese yen. Therefore, the internationalisation of the rupiah was confined mostly to the financial market. These actions encouraged both the banking and corporate sectors to borrow freely from external sources.

This liberalisation process, however, was not supported by efforts to strengthen public and corporate governance. Furthermore, the weakness in the availability and quality of data and information also compromised the quality of decision-making by the business sector and the government. Finally, the exchange rate regime at the time, which attempted to manage the fluctuation of the rupiah within a narrow band, was inconsistent with monetary policy to control inflation.

As an initial response taken in consultation with the IMF, Indonesia replaced the intervention band with a free floating exchange rate in August 1997. Under the new regime, market forces freely determined the rupiah exchange rate while the authorities influenced the market indirectly through fiscal and monetary policy. By switching to this new regime, the central bank hoped to dampen the speculative attacks on the rupiah as well as to obtain a stronger hold on domestic monetary developments. The opposite occurred as the rupiah's decline rapidly accelerated, as shown in Graph 1.

Although the crisis originated in an over-leveraged corporate sector and a banking sector that had mismatched assets and liabilities, the liquidity crunch that Asian borrowers faced after July 1997 quickly spun out of control, as heightened political and social tensions overwhelmed economic fundamentals. Our experience suggests that in a liberal financial system, financial markets can be subject to self-fulfilling panics, especially in the presence of highly leveraged positions. In a segmented and thinly traded foreign exchange market, exchange rate movements are extremely reactive to any change in sentiment - especially negative changes - and are subject to manipulation and herd behaviour. Although the rupiah was probably overvalued in mid-1997, the subsequent excessive overshooting and extreme volatility cannot be explained by the domestic macroeconomic situation.

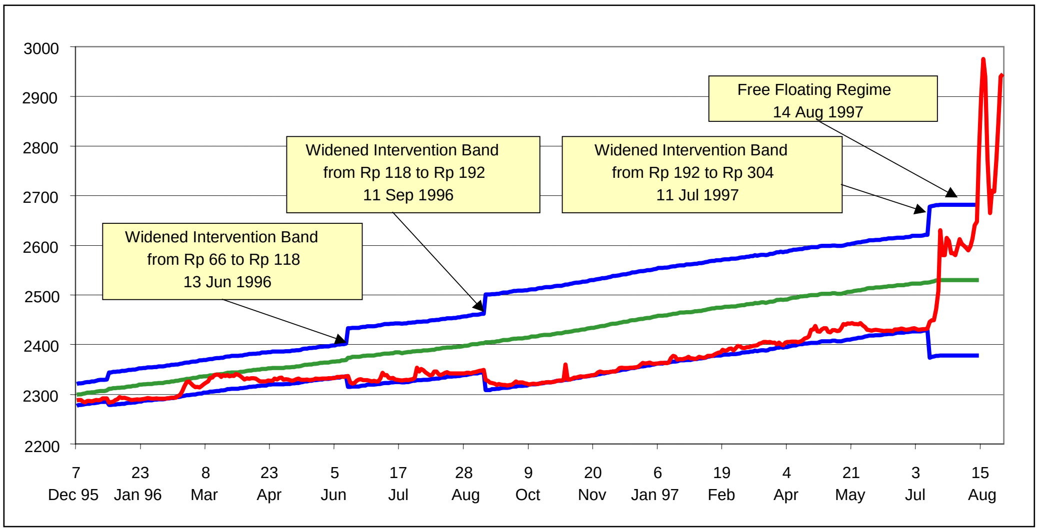
---

1 Hartadi A Sarwono, Deputy Governor of Bank Indonesia. E-mail: hartadi@bi.go.id.

2 Internationalisation of the rupiah in general can be defined as the use of the rupiah in international transactions, including trade (export or import), investment and financial market operations.

Graph 1

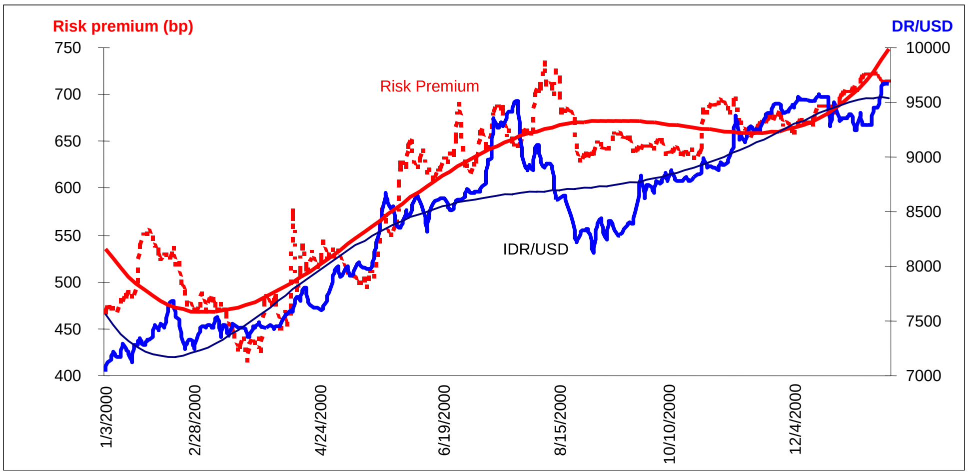
Managed floating to free floating exchange rate



At the time of the crisis, investors' sentiment turned negative as reflected in the risk premium - the spread of the Indonesian Yankee bond over the comparable US Treasury note. The internationalisation of the rupiah provided an opportunity for non-residents to take advantage of this loss of confidence and to speculate in the offshore rupiah market. Speculative activity in the rupiah intensified amid the lack of social and political stability in Indonesia. This caused excessive exchange rate volatility and made it difficult for monetary policy to maintain the stability of the rupiah, which had a negative impact on the overall macroeconomic situation. The weakening rupiah harmed macroeconomic stability through the pass-through impact on inflation, which led to higher interest rates than optimal to support economic and financial stability. Depreciation also affected the fiscal deficit, by raising the cost of external debt service as the rupiah value of the debt stock exploded.

Graph 2

The movement of rupiah and risk premium



Weakness in the currency persisted well after the initial panic subsided. During the first three years of the floating exchange rate system, the volatility of the rupiah remained high compared to other Asian countries, as illustrated in Table 1.

Table 1

Exchange rate volatility: 1995-2000

	1995	1996	1997	1998	1999	2000
A. Daily volatility[1]						
Indonesia	0.15	0.15	2.49	4.86	1.88	1.05
Korea	0.25	0.23	2.65	1.75	0.48	0.42
Philippines	0.28	0.05	1.31	1.19	0.45	0.58
Thailand	0.12	0.08	1.71	1.58	0.56	0.45
Malaysia	0.23	0.15	0.90	1.75	0.01	0.01
B. Monthly volatility[2]						
Indonesia	0.51	0.65	11.25	32.66	10.25	3.85
Korea	1.06	0.93	10.06	7.49	2.86	2.44
Philippines	1.50	0.09	5.09	4.85	1.83	3.44
Thailand	0.59	0.34	8.45	8.93	3.08	2.18
Malaysia	1.06	0.61	4.48	7.21	0.01	0.01

[1] Standard deviation from percentage changes of daily exchange rate. [2] Standard deviation from percentage changes of monthly exchange rate.

Source: IMF Working Paper 01/152.

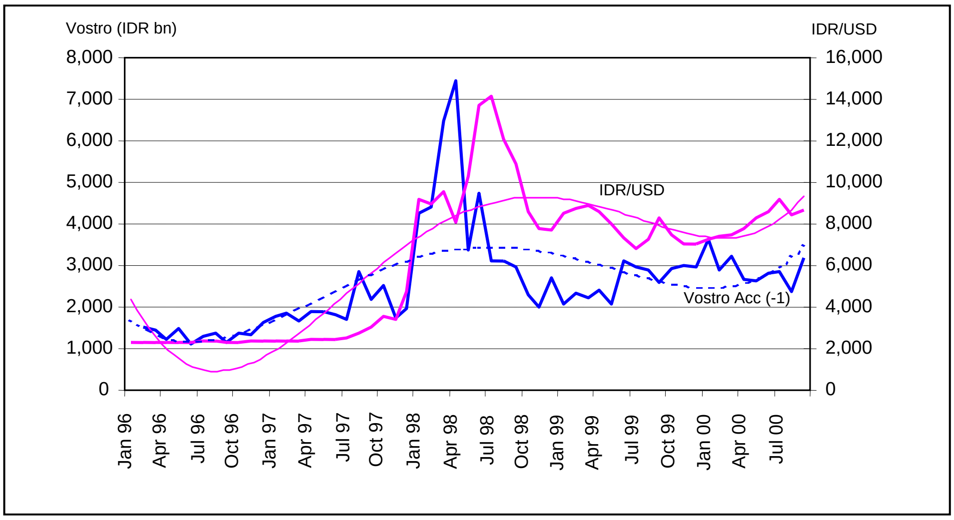
The negative impact of internationalisation of the domestic currency

The internationalisation of the rupiah allowed non-residents to play a large role in deciding the direction of the exchange rate as their activity was followed by traders in the local market. It is difficult to know the exact amount of offshore rupiah because this is beyond Bank Indonesia's jurisdiction. However, rupiah transactions by non-residents, and their role in affecting of the direction of the exchange rate, could be traced through their vostro accounts with onshore banks. Activity in these accounts tended to be high and volume increased during periods when the exchange rate was under heavy pressure as shown in Graph 3. Rupiah speculation by non-residents was made possible because of the relatively easy access to rupiah from onshore banks. In addition, ample liquidity in the domestic financial market was available since loan demand had dried up. With investment opportunities still limited, investing in the foreign exchange market was one attractive alternative for banks with excess liquidity.

The disparity between the volatility of the rupiah and the currencies of Asian countries that had taken measures to limit the internationalisation of their currencies led Bank Indonesia to evaluate existing regulations governing rupiah transactions with non-residents. Bank Indonesia determined that the offshore market for rupiah had induced greater volatility in capital flows and exchange rate movements. At times it had also complicated the efforts of Bank Indonesia to control the money supply.

Graph 3

Fluctuation in vostro account vs IDR/USD exchange rate



Bank Indonesia regulation

Because of these problems, it was deemed necessary to have a policy that would minimise the opportunity for non-residents to speculate against the rupiah. Therefore, Bank Indonesia issued Regulation no 3/3/2001 on 12 January 2001, which limited rupiah transactions between onshore banks and non-residents.

To this end, we designed policies to reduce the volatility of the rupiah exchange rate that originated from foreign exchange trading without underlying economic transactions, while maintaining our commitment to a free foreign exchange regime. The opportunity of non-residents to speculate on the rupiah would be curtailed through the limitation in accessing credits from the domestic banking system. Therefore, Bank Indonesia issued a regulation restricting rupiah transactions and foreign currency credit offered by banks to non-residents. The regulation consisted of two major parts, namely restrictions on certain transactions by banks with non-residents without any exception and limitations on derivative transactions with non-residents, with some exceptions.

The coverage of the regulation is as follows:

1. Prohibits banks from extending loans and providing other sources of rupiah funding to non-residents including:
   - Rupiah and foreign exchange loans to non-residents, including intraday overdrafts;
   - Placement of rupiah in the form of deposits or other means in offshore banks;
   - Investment in rupiah-denominated assets issued by non-residents;
   - Inter-office transactions in rupiah (domestic branch lending to offshore branches);
   - Equity participation in rupiah by non-residents.
2. Restricts banks from conducting derivative transactions without underlying transactions. Restricted derivative transactions encompass:
   - Forward sales, including next day and spot currency transactions rolled over as synthetic transactions replicating foreign currency forward sales;
   - Swap sales including overnight and next day swaps;
   - Transactions involving the selling of foreign currency puts against the rupiah.

3. Prohibits banks from transferring rupiah to non-residents without underlying economic activities in Indonesia.

- Transferring rupiah from residents to non-residents is prohibited, except:
  - Settlement of forex buying against the rupiah;
  - Settlement on NR accounts with onshore banks related to domestic economic activities such as equity participation, securities transactions, foreign debt repayment in rupiah, import L/Cs in rupiah, goods and services purchased in Indonesia, and NR living costs in Indonesia.
- Transferring rupiah from non-residents to non-residents is prohibited, except:
  - Settlement of forex transactions;
  - Settlement on NR accounts with onshore banks related to domestic economic activities such as equity participation, securities transactions, goods and services purchased in Indonesia, and NR living costs in Indonesia.

Evaluation

We recognised that these restrictions did not automatically contain exchange rate fluctuations. There are many factors, including non-economic factors, that affect the value of the rupiah. As in most segmented and thin markets, the rupiah exchange rate is largely event driven. The social and political turmoil experienced during 2001 contributed heavily to the difficulty of measuring the effectiveness of Bank Indonesia's regulations in reducing the rupiah exchange rate volatility. Nevertheless, the evidence of the exchange rate volatility during the first two months after the introduction of this regulation showed some encouraging results. The rupiah's volatility fell from an average of 2.2% in 2000 to 0.8% and 0.9% in January and February 2001, respectively, while the average balances of daily vostro accounts also fell substantially from Rp531.6 billion before the regulation to Rp88.6 billion after its issuance or less than 20% of its previous average balance.

Reviews of the regulation's effectiveness have been conducted regularly since its implementation. Hence, some areas will be subject to further improvement. One major objection to the regulation has been the impact in curbing access to the rupiah for hedging purposes, especially to cover unrealised investments. Under the existing regulation, investors who have already signed an agreement to invest but have not executed the transaction are banned from hedging facilities, as no underlying transaction has been executed. Therefore, one proposal for improvement includes the extension of the coverage of derivative transactions for hedging purposes under the above circumstances and a better definition on technical issues, such as the definition of credit, sanctions, as well as the clarification of several operational issues.

Concluding remarks

Limiting the availability of the rupiah to non-residents is not the only answer to achieve stability of the rupiah exchange rate. Many factors contribute to the fluctuation of the rupiah. The Indonesian foreign exchange market is volatile not only because of its structure but also due to political and macroeconomic developments. Nevertheless, with the current regulation, we have minimised the opportunities to undertake speculative activities by taking advantage of non-economic factors so that the rupiah exchange rate will more closely reflect economic fundamentals, thereby easing the task of Bank Indonesia, the central bank.