Financial Fragility and Instability in Indonesia

Yasuyuki Matsumoto
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This book examines the underlying causes of the financial crisis that struck Indonesia during the second half of 1997 and 1998. It argues that the roots of the crisis lay in the financial activities undertaken by the Indonesian corporate sector during the boom years from 1994 to 1997, which encouraged the development of fragile and unstable financial structures, involving increased corporate leverage, reliance on external debt and the introduction of riskier and more complicated financial instruments and transactions. It goes on to consider four detailed conglomerate-level case studies that illuminate the microeconomic foundations of the crisis, showing how Indonesian capitalists sought to liquidate their Indonesian assets without losing control of their corporate empires, by taking advantage of increased access to foreign loans and complex financial re-engineering actions which ultimately precipitated instability and crisis throughout the entire financial system. Finally, it reflects upon the policy implications of this episode, putting forward the case for comprehensive capital controls for open and developing economies until they establish appropriate financial institutions to monitor and manage the level of indebtedness and the volatility of capitalists’ behaviour. Overall, this book provides incisive analysis of a critical phase in recent East Asian financial history.

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13 Financial Fragility and Instability in Indonesia
   Yasuyuki Matsumoto
Financial Fragility and Instability in Indonesia

Yasuyuki Matsumoto
To Kanako and Marina
and
To the Memory of
Katsu Yanaihara and Takashi Uehara
Contents

List of figures xi
List of tables xiii
Preface xvii
Acknowledgements xix
List of abbreviations xxiii
Short profile of author xxvii

Introduction 1

1 Indonesia’s external debt problem in the 1990s 4
   The East Asian crisis and Indonesia 4
   Review of Indonesian external debt data in the 1990s 8
   External versus domestic private debt 10
   Instruments, markets and players 13
   The development of Indonesia’s speculative financing position during the 1990s 14

2 Minsky’s financial instability hypothesis: interpretation and critical adjustments for the Asian context 16
   Theorizing the East Asian financial crisis 17
   Minsky’s financial instability hypothesis 24
   Adjustments, corrections and clarifications of Minsky’s model in the context of Asian economies in the 1990s 33

3 Methods and databases for empirical studies 44
   Methods and database for the analysis of the financial positions of the Indonesian corporate sector 45
Contents

Methods and database for the analysis of offshore syndicated debt for Indonesian borrowers 53
Case studies of financial activities by Indonesian business groups during the finance boom 57

4 The financial positions of the Indonesian corporate sector in the 1990s 61

Overview of the corporate sector’s financial positions in the 1990s 62
Shifts in the corporate sector’s financial positions during the 1990s 71
Conclusions 82

5 The analysis of offshore syndicated debt for Indonesian borrowers during the finance boom in the 1990s 84

The scale of offshore syndicated debt for Indonesian borrowers during the finance boom 84
The downward diversification of Indonesian borrowers’ offshore syndicated debt during the finance boom 87
Borrowing terms of offshore syndicated debt for Indonesian borrowers during the finance boom 91
Interpretations of the improvement of borrowing terms for Indonesian borrowers during the finance boom 101

6 Case study 1: the Salim Group’s financial activities in the 1990s 109

General views on the Salim Group 109
The Salim Group’s financial position 111
The Salim Group’s offshore fund-raising activities 114
The Salim Group’s corporate restructuring and asset transfers in the 1990s 120
Conclusions 127

7 Case study 2: the Lippo Group’s financial activities in the 1990s 130

General views on the Lippo Group 130
The Lippo Group’s financial activities and results during the finance boom of the 1990s 133
The Lippo Group’s corporate restructuring and liquidation of its investments in the 1990s 137
Conclusions 142
8 Case study 3: the Sinar Mas Group’s financial activities in the 1990s

General views on the Sinar Mas Group 144
The Sinar Mas Group’s shareholding structure in the 1990s 145
The Sinar Mas Group’s financial positions in the 1990s 147
The Sinar Mas Group’s financial activities during the finance boom 150
Conclusions 158

9 Case study 4: the Gajah Tunggal Group’s financial activities in the 1990s

General views on the Gajah Tunggal Group 160
The Gajah Tunggal Group’s financial position during the finance boom 161
The Gajah Tunggal Group’s fund raising during the finance boom 163
The Gajah Tunggal Group’s corporate restructuring and the encashment of the Nursalim family’s investments in the 1990s 167
Conclusions 170

10 The collapse of cash-flow chains

The Indonesian crisis and the institutional arrangements carried out by the government 172
Business groups’ struggles during and after the crisis 177

11 Conclusions

Notes 202
Bibliography 234
Index 249
## Figures

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Minsky’s closed market model</td>
<td>30</td>
</tr>
<tr>
<td>6.1</td>
<td>The Salim Group’s internal asset transfer in 1995</td>
<td>122</td>
</tr>
<tr>
<td>6.2</td>
<td>The disposal of the Salim family’s palm oil businesses to Indofood in 1997</td>
<td>124</td>
</tr>
<tr>
<td>6.3</td>
<td>The planned ownership transfer of Indofood to offshore in 1997</td>
<td>126</td>
</tr>
<tr>
<td>7.1</td>
<td>The restructuring of the Lippo Group financial service division in Indonesia</td>
<td>138</td>
</tr>
<tr>
<td>7.2</td>
<td>The Lippo Group’s investment structure in Hong Kong (pre-1997 restructuring)</td>
<td>140</td>
</tr>
<tr>
<td>7.3</td>
<td>The Lippo Group’s investment structure in Hong Kong (post-1997 restructuring)</td>
<td>140</td>
</tr>
<tr>
<td>7.4</td>
<td>The not-realized restructuring of the Lippo Group’s urban development division</td>
<td>142</td>
</tr>
<tr>
<td>8.1</td>
<td>The Sinar Mas Group’s shareholding structure for Indonesian operations</td>
<td>146</td>
</tr>
<tr>
<td>9.1</td>
<td>The restructuring of the Gajah Tunggal Group’s manufacturing division</td>
<td>167</td>
</tr>
<tr>
<td>9.2</td>
<td>The restructuring of the Gajah Tunggal Group’s financial services division</td>
<td>170</td>
</tr>
</tbody>
</table>
Tables

1.1 Indonesian external debt 1989–98 8
1.2 Annual growth of Indonesian external debt 9
1.3 Share of Indonesian external debt 9
1.4 External and domestic debts by Indonesian private sector 11
1.5 Annual growth of Indonesian private sector’s external and domestic debts 11
1.6 Indonesian corporate sector’s reliance on external and foreign currency debts 12
3.1 Financial ratios for leverage 46
3.2 Financial ratios for liquidity 47
3.3 Financial ratios for profitability and debt-service capacity 47
3.4 Database of Indonesian corporate and financial sector 51
3.5 Indonesian–Chinese active stock market users 52
3.6 Database of offshore syndicated loans for Indonesian borrowers 55
3.7 Top-tier credit corporate borrowers in Indonesia 56
4.1 Financial ratios of the Indonesian corporate sector 64
4.2 The changes of financial ratios of the Indonesian corporate sector 65
4.3 Financial ratios of 50 private non-financial companies 66
4.4 The changes of financial ratios of 50 private non-financial companies 67
4.5 Financial ratios of the Indonesian private non-bank sector 68
4.6 The changes of financial ratios of the Indonesian private non-bank sector 69
4.7 Financial ratios of 187 private non-financial companies 70
4.8 The changes of financial ratios of 187 private non-financial companies 70
4.9 Major economic indicators for Indonesia 74
5.1 Offshore syndicated debts for Indonesian borrowers (by volume) 85
5.2 Offshore syndicated debts for Indonesian borrowers (by share) 85
5.3 Debtors’ concentration in offshore syndicated debts for Indonesian business groups 87
## Tables

5.4 Offshore syndicated debts for Indonesian business groups (by the number of transactions) 88
5.5 Offshore syndicated debts for Indonesian business groups (by the funding amount) 89
5.6 Average tenor of offshore syndicated debts for Indonesian borrowers 93
5.7 Average all-in margins of offshore syndicated debts for Indonesian borrowers 93
5.8 Average tenor of offshore syndicated debts for Indonesian banks 95
5.9 All-in margin of offshore syndicated debts for Indonesian banks 95
5.10 The borrowing terms for the leading five state commercial banks 97
5.11 Borrowing terms for the leading five private banks 99
5.12 Average tenors of offshore syndicated debts for Indonesian non-bank borrowers 100
5.13 Average all-in margins of offshore syndicated debts for Indonesian non-bank borrowers 101
5.14 Direct benefits from offshore loans for offshore lenders and Indonesian borrowers 107

6.1 The Salim Group’s financial position 111
6.2 The Salim Group’s profitability, financial costs and debt-service capacity 114
6.3 The Salim Group’s offshore syndicated debts: 1993–7 (summary) 115
6.4 The Salim Group’s offshore syndicated debts: 1993–7 (breakdown) 118
7.1 The Lippo Group’s syndicated debts during the 1990s boom 134
7.2 The Lippo Group’s fund raising through the Jakarta stock exchange during the 1990s finance boom (summary) 135
7.3 The Lippo Group’s fund raising through the Jakarta stock exchange during the 1990s finance boom (breakdown) 135
7.4 The Lippo Group’s financial position in the 1990s 136
8.1 The Sinar Mas Group’s financial position 148
8.2 The Sinar Mas Group’s equity finance in the 1990s boom (summary) 151
8.3 The Sinar Mas Group’s equity finance in the 1990s boom (breakdown) 152
8.4 Offshore syndicated debts for the Sinar Mas Group (transactions, US$ million) 152
8.5 Offshore syndicated debts for the Sinar Mas Group (pulp and paper) 153
8.6 Offshore syndicated debts for the Sinar Mas Group (agribusiness) 154
<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.7</td>
<td>Offshore syndicated debts for the Sinar Mas Group (real estate development)</td>
<td>155</td>
</tr>
<tr>
<td>8.8</td>
<td>Offshore syndicated debts for the Sinar Mas Group (financial services)</td>
<td>156</td>
</tr>
<tr>
<td>8.9</td>
<td>Offshore syndicated debts for the Sinar Mas Group (others)</td>
<td>157</td>
</tr>
<tr>
<td>8.10</td>
<td>Fixed income bonds issued by the Sinar Mas Group</td>
<td>158</td>
</tr>
<tr>
<td>9.1</td>
<td>The Gajah Tunggal Group’s financial position in the 1990s</td>
<td>162</td>
</tr>
<tr>
<td>9.2</td>
<td>The Gajah Tunggal Group’s equity finance during the finance boom (summary)</td>
<td>163</td>
</tr>
<tr>
<td>9.3</td>
<td>The Gajah Tunggal Group’s equity finance during the finance boom (breakdown)</td>
<td>164</td>
</tr>
<tr>
<td>9.4</td>
<td>The Gajah Tunggal Group’s offshore syndicated debts (summary)</td>
<td>164</td>
</tr>
<tr>
<td>9.5</td>
<td>The Gajah Tunggal Group’s offshore syndicated debts (breakdown)</td>
<td>165</td>
</tr>
</tbody>
</table>
This book applies Hyman P. Minsky’s financial instability hypothesis, with necessary modifications, to the Indonesian case. Indonesia experienced an extreme boom-bust cycle within ten years of liberalization. The book argues that the fragile and unstable financial structures, which ultimately led to the financial crisis, emerged during the finance boom from 1994 to the first half of 1997. The increase in corporate leverage, the increasing reliance on external debt and the introduction of riskier and more complicated financial transactions and structures were all characteristic of the boom.

Indonesia in the 1990s experienced an era of private capital mobilization. The corporate sector, that is, private non-financial companies, played an important role in mobilizing private capital. During the finance boom, the sector drove up leverage through the use of offshore syndicated debt. The sector rapidly increased its reliance on foreign currency debt, and at the same time, offshore mobile capital occupied a dominant position in the financial structure. As a result, the sector became in Minsky’s terms a highly leveraged ‘speculative financing unit’.

The process was driven by business groups’ aggressive financial activities and offshore financiers’ enthusiasm for Indonesian assets. The business groups initiated complex financial activities during the boom. The finance boom enabled business group owners not only to make new investments without the need for additional capital contributions, but also to liquidate their Indonesian investments. Four case studies of Indonesian business groups (Salim, Lippo, Sinar Mas and Gajah Tunggal) provide detailed accounts of the endogenous evolution of fragile and unstable financial structures at the microeconomic level.

Finally this book reviews the collapse of Indonesia’s fragile and unstable financial structures during the financial crisis.
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