SECTOR ASSESSMENT (SUMMARY): FINANCE

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. The Indonesian economy is at a crossroads. Economic growth has steadily declined from 6.4% in 2010 to 4.7% year-on-year in the first quarter of 2015 and projected to grow at 5.0% in 2015, underperforming its regional peers.[1] This is mainly because the commodity price boom ended and macro policies were tightened to lower inflation, curb the current account deficit, and stabilize the rupiah exchange rate. The economy is expected to pick up and grow at 5.6% in 2016, which is in line with Indonesia's estimated potential economic growth rate in the 5.0% range (footnote 1)[2] While the sharp decline in commodity prices is most likely cyclical, it has exposed structural weaknesses in the economy including competitiveness of the real sector and inadequate investments in infrastructure. Indonesia needs a new source of export growth to meet its ambitious economic growth target of 8.0% by 2019. This will require acceleration in public and private infrastructure investments to improve the competitiveness of the economy, reforms to the investment climate,[3] development of a more competitive workforce (only about 10.0% of the workforce holds tertiary education qualifications), and fiscal reforms.

2. Against this backdrop of slower economic growth and structural adjustment, the government has been challenged by a significant rise in household income inequality since 2010, as reflected in the increase in the Gini index from 0.38 in 2010 to 0.41 in 2013 (the Gini index in urban areas is higher, at 0.43 in 2013), which can lead to socioeconomic problems.[4] In addition, a sizeable share of the population is excluded from the financial system, so opportunities to raise the incomes of the poor through savings and pensions, and to mitigate financial risks arising from natural disasters and economic shocks, are lost.

3. A growing body of empirical research produces a remarkably consistent story—that the services provided by the financial system exert a positive impact on long-run economic growth. Empirical evidence also shows that financial sector development is critical for reducing the incidence of poverty through better access for the poor and low-income families to financial products and services.

4. **A major development problem** faced by Indonesia is the under developed financial sector and shallow capital market. The Indonesian financial sector remains small compared with its regional peers (Figure 1). In 2013, financial sector assets (bank credit, market capitalization, and bonds) to gross domestic product (GDP) were 103% compared with about 194% for the Philippines, and over 300% of GDP for Malaysia, Singapore, and Thailand. Moreover, this share of financial sector assets to GDP has been relatively constant in Indonesia since 2010 indicating that deepening of the financial sector remains a challenge since the end of the global financial crisis (Figure 1). In the equity market, although the number of listed companies in the stock market increased to 506 in 2014 from 440 in 2011, market capitalization as a percentage of GDP in 2014 is below 50%, whereas Association of Southeast Asian Nations (ASEAN) comparators

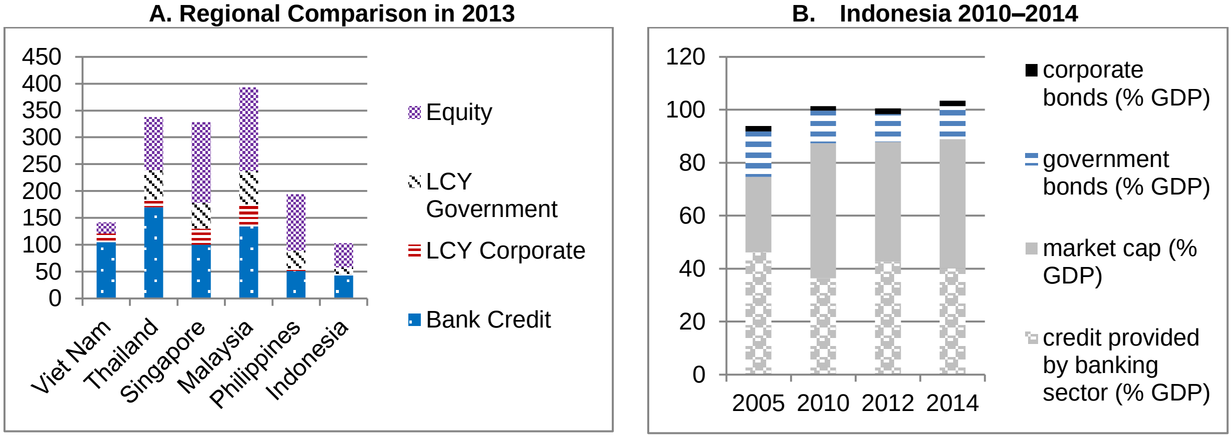
---

[1] ADB. 2015. *Asian Development Outlook 2015 Supplement.* Manila
[2] International Monetary Fund Assessment Letter (accessible from the list of linked documents in Appendix 2).
[3] According to the World Bank. 2015. *World Bank Doing Business Report.* Washington, DC, Indonesia is ranked 114 out of 189 countries, a slight improvement of three places over its 2014 ranking. This ranking is lower than its regional peers—Malaysia (ranked 18), Thailand (26), Viet Nam (78), and Philippines (95).
[4] Statistics are based on the Government of Indonesia's Statistics Office, http://www.bps.go.id/linkTabelStatis/view/id/946, (accessed 20 July 2015).

all exceeded 90% of their respective GDPs. The local currency bond market is also small, accounting for only 2% of GDP—a fraction of that of its ASEAN peers. Some of the reasons for the small size of the financial sector are: (i) fragmented regulatory structure; (ii) regulatory framework that is not in line with international best practices; and (iii) enabling environment that is less conducive to financial sector development including lack of diversity in capital market products.

Figure 1: Financial Sector Assets to Gross Domestic Product

A. Regional Comparison in 2013 **B. Indonesia 2010–2014**



GDP = gross domestic product, LCY = local currency

Sources: Asian Bonds Online. http://asianbondsonline.adb.org/; Asian Development Bank. 2014. *Key Indicators for Asia and the Pacific 2014*. Manila.

5. **Vulnerability** to external financial shocks is another development problem. Indonesia has an open capital account, the Indonesian bond market is still largely influenced by external factors as nearly one-third of government bonds are held by foreign investors, leaving the market vulnerable to the risk of sudden capital outflows. In the past, Indonesia has experienced sharp reversals in capital flows from modest to strong external shocks. For example, in June 2013, there was a capital outflow of IDR15.76 trillion in the bond market with foreign investors as net sellers. This instability resulted in higher cost of borrowing as the 10-year government bond yield increased by 225 basis points between April and July 2013 whereas the bond markets of Malaysia and the Philippines, where economic fundamentals are stronger, have shown smaller increases in bond yields.[5] As of July 2015, Indonesia's 5-year CDS spread of government bonds is at 170 basis points per annum compared with 90–120 basis points for Malaysia, the Philippines, and Thailand.[6] This vulnerability is partly due to the shallow financial sector, which is unable to provide a buffer to external shocks. Another key reason is that the financial stability framework and crisis management protocol are still being developed. The high financial system risks transmit to higher cost of borrowing.

6. **Financial exclusion.** This is another development problem in Indonesia related to an underdeveloped financial sector. Only 21.9% of the poorest 40% of the Indonesian population has savings at a financial institution. Furthermore, over 40% of the population does not borrow, with only 13.1% having borrowed from a financial institution. This means a sizeable share of the population is excluded from the financial sector, with limited opportunities to increase wealth through savings and mitigate financial risks to their livelihoods from natural calamities and economic shocks. The main challenges in this area are low access to financial services,

---

[5] ADB.2013.*Asia Bond Monitor September 2013.* Manila.
[6] Data are based on Asian Bonds Online, http://asianbondsonline.adb.org (accessed 6 August 2015).

impediments to the delivery and usage of noncredit financial products and services, the low level of financial literacy, and weak consumer protection. Promoting financial inclusion is an opportunity to address this development problem, as increasing basic savings—especially among the poorest population—can raise income levels and reduce gaps in income distribution.[7]

2. Government's Sector Strategy

7. The government set targets of 8.0% GDP growth and reducing poverty to 7.0%–8.0% in the National Medium Term Development Plan, 2015–2019.[8] It recognizes that promoting financial stability, capital market development, and improving access to financial services, are integral to addressing these challenges. The plan targets the financial sector growing by 10.4% per annum by 2019 compared with 8.2% in 2014. The government also targets providing access to financial services to 25% of the poorest 40% of the population by 2019.

8. The government's strategy is complex because the anchor to its longer term financial sector reforms and development is the successful and effective implementation of the Financial Services Authority (OJK) mandate—building its capacity for surveillance, monitoring and mitigating risks to the financial system, and introducing innovations to deepen the capital market. The reform strategy consists of a sequenced series of reforms focusing on three pillars: (i) implement OJK's mandate as an independent unified regulator, as a prerequisite for anchoring financial system stability and capital market development; (ii) implement concurrent measures to deepen the capital market; and (iii) improve financial inclusion over the longer term.

9. From January 2014, OJK took over the banking supervision function from Bank Indonesia in January 2014 and became the unified regulator of all three subsectors. To support this integrated mandate, OJK's strategy is to (i) identify key priority areas for a consolidated financial sector master plan, (ii) approve its information technology blueprint to consolidate the regulatory processes of the different subsectors using information technology systems, and (iii) move toward fiscal independence. On financial stability, the approach of the government and OJK is to strengthen the framework for financial stability, including setting up an interagency coordination mechanism and developing a crisis management protocol. The government, through the Fiscal Policy Agency, established the Center for Financial Sector Policies as its main coordination mechanism.

10. OJK's commitment to adopt international standards and promote regional integration to deepen its financial sector is demonstrated by its adoption of international best practices and ASEAN standards. For the capital market, OJK completed all legal requirements and became a full member of the International Organization of Securities Commissions. To strengthen its corporate governance framework for publicly listed companies, OJK adopted the ASEAN Corporate Governance Scorecard, launched Indonesian's Corporate Governance Roadmap for publicly listed companies, and issued corporate governance regulations. The government improved the enabling environment for financial market development by diversifying capital market products on the supply side and reforming the contractual savings sector (insurance and pension) on the demand side. To increase market liquidity, OJK introduced the global master repurchase agreement to facilitate market-making and hedging.

---

[7] Summary Poverty Impact Assessment (supplementary appendix accessible from the list of linked documents in Appendix 2).

[8] Badan Pengawasan Keuangan Dan Pembangunan. National Medium Term Development Plan. http://www.bpkp.go.id/sesma/konten/2254/Buku-I-II-dan-III-RPJMN-2015-2019.bpkp (accessed 20 July 2015).

11. The government and OJK have developed the financial market for all segments of society, including the poor and disenfranchised groups of the community. The government enacted the Law on Microfinance Institutions in 2015 and OJK signed memorandums of understanding with the Ministry of Home Affairs and the Ministry of Cooperatives to coordinate and promote financial services at the national and local level. OJK also launched a branchless banking initiative, which allows registered agents to offer basic banking services to areas without a commercial bank presence. OJK strengthened investor confidence by enhancing consumer protection mechanisms for retail investors. This is important for market integrity and to encourage more domestic investment. OJK launched the Financial Customer Care initiative in 2014, which consists of an information submission service, an information request service, and a complaint handling service. By the end of 2014, OJK had received 27,000 requests from consumers. It also authorized the establishment of the Securities Investor Protection Fund, with an initial fund size of Rp45,000,000,000, to provide assurances against investor losses resulting from fraud or misappropriation of funds.

3. ADB Sector Experience and Assistance Program

12. ADB has had a long-term engagement with the government on financial sector development. It has undertaken six major financial sector operations in Indonesia since 1998, aimed at sequentially addressing banking, capital markets, contractual savings, and most recently reform of the regulatory framework. One of the most significant financial sector reforms was the creation of OJK. This can be traced to 1999 when, following policy dialogue between the government and ADB, Parliament passed the Banking Law to insulate the regulatory and supervisory framework from political interference. The legislation required the establishment of the Consolidated Supervisory Authority for Financial Services by the end of 2002. The government asked ADB to support the development of a blueprint to set up OJK. ADB responded through the Financial Governance and Social Security Reform Program of 2002 including supporting regulatory reform to establish OJK.[9] However, with the financial crisis of 1997–1999, and concerns about the transition from several regulators to one, Parliament postponed the establishment of OJK from 2002 to 2010. The financial governance reform program was followed by ADB's capital market development program and technical assistance (TA) grant in 2007, which focused on strengthening market surveillance and investor protection.[10] The OJK law was enacted in 2011, and OJK started implementing its mandate to regulate the capital market and nonbank financial institutions in December 2012. The initial focus on the capital market and nonbank financial institutions was supported by ADB's Financial Market Development and Integration Program approved in 2012.[11] Key areas of FMDIP are to (i) support OJK to develop a consolidated financial sector road map, (ii) promote deeper capital markets through new products and services, and (iii) promote financial inclusion products. Assistance is provided through a programmatic approach, supported by national TA, and supplemented by ADB regional TA on ASEAN capital market integration and implementation of prudential standards in Islamic finance. This approach embeds regional integration and international best practices as key considerations for national financial sector development.

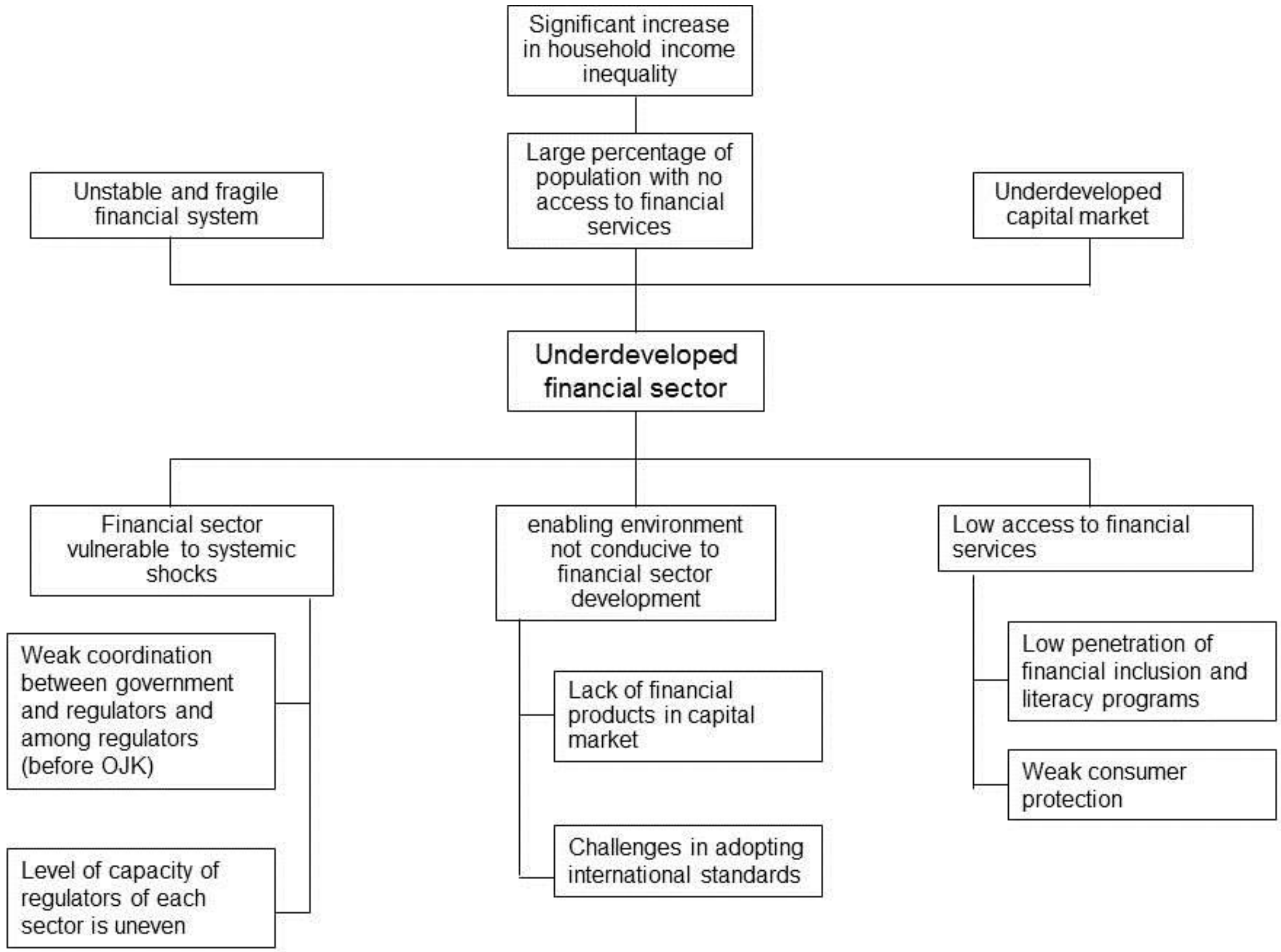
---

[9] ADB. 2002. *Report and Recommendation of the President to the Board of Directors: Proposed Cluster, First Loan and Technical Assistance Grant to the Republic of Indonesia for the Financial Governance and Social Security Reform Program.* Manila.

[10] ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Republic of Indonesia for the Capital Market Development Program Cluster (Subprogram 1)*. Manila.

[11] ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan to the Republic of Indonesia for the Financial Market Development and Integration Program*. Manila.

Problem Tree for Finance



OJK = Otoritas Jasa Keuangan (Financial Services Authority)

Sector Results Framework (Finance, 2016–2019)

Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	**Indicators with Targets and Baselines**	**Outputs with ADB Contribution**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Interventions**
Increased development and inclusiveness of financial sector	Reduction in 5 year CDS spreads by 20 basis points (Baseline average 2013-2015: 176.1 basis points) Size of financial sector as percentage to GDP increase by 12%. (Baseline 2014: 103%) Access of financial services to the 40% poorest increased to 25% (Baseline 2014: 21.9%)	Regulatory structure for financial stability strengthened Financial market deepened Access to financial services enhanced	OJK implemented road map with specific targets and monitoring mechanism that is regularly reported (Baseline 2015: road map being developed) Government submits revised law on capital market (Baseline 2015: law being drafted) Capital market developed with diverse products for all segments including for hedging purposes (Baseline 2015: capital market consist of equity products only) OJK implemented 50% of IFSB standards issued by end of 2015 (Baseline 2015: 12%, 2 out of 17) OJK conducted financial literacy programs in at least 84 cities and 24 outreach programs. (Baseline 2015: 24 cities and 4 outreach programs	**Planned key activity areas** Finance sector development, development of consolidated financial sector master plan and capacity building support for center of Financial Sector Policies and OJK **Pipeline projects with estimated amounts** Ensuring Comprehensive Financial Sector Development and Oversight I ($1.5m) **Ongoing projects with approved amounts** Financial Market Development and Inclusion Program ($400 million)	**Planned key activity areas** Policy-based and capacity development to support finance sector development **Pipeline projects** TA support for financial inclusion **Ongoing projects** Regulatory structure for financial stability strengthened Financial market deepened Access to financial services enhanced

ADB = Asian Development Bank, GDP = gross domestic product, OJK = Otoritas Jasa Keuangan (Financial Services Authority).
Source: Asian Development Bank.