Journal of Indonesian Economy and Business
Volume 26, Number 1, 2011, 10 – 24

THE POLITICS OF BANK SUPERVISION

Widigdo Sukarman

Universitas Gadjah Mada and Universitas Negeri Manado
(widigdo.sukarman@gmail.com)

ABSTRACT

The bank supervision function and efficacy of monetary policy are often a trade-off for the central bank. An increasingly integrated financial system and the occurrence of bank crises during the 1980s raised the question: are central banks efficient in overseeing banks and is there a requirement for integrated supervision, either under the central bank or separate? The debate among academics and policymakers has never been settled without the guarantee that one alternative will ensure optimal bank supervision. This development has led to periodic changes in the form of supervision chosen. As the basic economic choice has been unsatisfactory, this study approaches the problem using path-dependence theory, which observes historical factors of bank development as well as the constellation of domestic politics in choosing these alternatives.

Keywords: *path-dependence, bank supervision, politics, country-specific*

INTRODUCTION

Why are banks so special? Banks occupy a special place in the economy because of their ability to transform short-term savings, which constitute public assets, into long-term loans. Furthermore, banks also effectuate the payment system of a country and between countries. In the event of a bank rush, the bank cannot readily conduct a reverse transformation, thereby triggering a liquidity crunch, which can spread and become a systemic liquidity crisis that threatens the national economy (Diamond and Dybvig, 1983). Consequently, public intervention is required, for example through a deposit insurance corporation, lender of last resort, prudential regulations and bank supervision from the central bank. Bank regulation and supervision are a complicated issue, namely the problem for regulators is that there is no single optimal way to regulate banking (Smith, 1990; Bhattacharya and Thakor, 1993).

Economic development, which changed rapidly among industrial countries during the second half of the 20th century, led to integrated bank, securities and insurance institutions and, therefore, the emergence of financial conglomerates. This situation necessitated a response in terms of financial reforms that would bring changes in institutionalization, competition and innovation in products and services such as securitization. The growth in funds, which could not be absorbed by these markets, searched for broader markets. Concomitantly, markets in emerging countries were performing well despite their economies being protected from new entries, hence, the industrial countries sought to open these emerging markets. The Washington Consensus 1989 was used as a reference to release the regulatory shackles in emerging markets through reforms. Various sweeping reforms that spanned nearly the entire globe during the 1980 striggered instability and, as forewarned by Davis (1995), the resulting dynamics gave grounds for expecting a permanent increase in instability.

Numerous crises struck during the 1980s as a result of reforms as well as other triggers. This instability precipitated distrust in central banks as bank overseers due to the lack of bank crisis prediction and handling, which threatened monetary stability. An idea emerged at around the same time in industrial countries that central banks should be independent and, therefore, isolated from short-term political pressures when carrying out their primary purpose of maintaining price stability (Goodman, 1992; Maxfield, 1997*;* Bernhard, 2005). Consequently, the task of bank supervision should be outsourced. However, the financial services industry is integrated. Therefore, supervision is more efficient if kept under one roof, without distinguishing whether it remains at the central bank or elsewhere.

The notion that supports the separation of bank supervision from the central banks terms from avoiding a conflict of interest with monetary policy (Heller, 1991; Goodhart and Schoenmaker, 1992; Goodhart, 2000). Conversely, proponents for unifying the two functions under the central bank argue the complementarity between supervisory and monetary policy responsibilities, at a minimum because the conduct of monetary policy requires full access to supervisory information in order to obtain timely and reliable data (Peek, Rosengreen and Tootell, 1999; Mishkin, 1992; de Krivoy, 2000).The majority of central bankers also defend the unification of supervision under the central bank as an umbrella (Haubrich and Thomson, 2005; opinion of ex-Governor of BI Burhanuddin Abdullah, 2009; Grenville, 2009; Bernanke, 2010).

A third opinion states that it is not important where supervision is located as long as its task is implemented efficiently (see Bank of England's 7th Central Bank Governors' Symposium 2000, opinion ofex-Governor of BI Sudradjad Djiwandono, early 2000). It is noteworthy that although Goodhart (2000: 34-42); Cihak and Podpiera (2006) opine that bank supervision should be independent from the central bank in industrial countries. They further more argue that it should come under the auspices of the central bank in emerging countries due to a number of reasons. One of the more salient reasons, according to the findings of Peek, Rosengreen and Tootell (1999), is that credit markets in emerging countries are usually bank-centric.

This choice of bank supervision structure has remained the subject of debate ever since among academics as well as policymakers without conclusive results. In practice, several countries have separated the supervision function from the central bank and formed an integrated supervisory body. Separation has occurred in UK (1997), Japan (1998), Korea (1998) and Australia (1998) with various supervision structures considered appropriate to their respective requirements. Several Scandinavian countries have historically separated supervision from the task of the central bank, meanwhile in US despite insistence to form a supervisory body outside of the Federal Reserve Bank, the Fed remains adamant to retain bank supervision (for example read the speech of Governor Ben Bernanke in front of the US Senate, 10th January, 2010).

However, circumstances can change rapidly. The global banking crisis in 2008, which stemmed from the subprime debt debacle at US banks, forced many countries to rethink their current systems of bank supervision, to either return to the original system or modify their reforms (Masciandaro and Quintyn 2008). In 2009, UK restored bank supervision to the central bank after the FSA failed to handle the Northern Rock crisis in 2007. Meanwhile, Indonesia continues to prepare legislation for the *Otoritas Jasa Keuangan (OJK)* (Financial Services

Authority) that will be separate from Bank Indonesia pursuant to the mandate of The BI Act no. 23/1999 article 36. The introduction of this legislation, which has been delayed many times, must be completed by year end 2010.The question that now emerges is whether the establishment of OJK should actually be continued or whether it should be reconsidered as in the case of numerous other countries that have subsequently abandoned the idea of separation?

RESEARCH METHODOLOGY

Hitherto, the existing panoply of empirical research has offered no optimal or definitive supervision structure, and the basic economic arguments used have not yielded any convincing results. Therefore, it is necessary to seek other reasons, non-economic reasons, which determine the choice of supervision system. Some research has concluded that the choice of bank supervision structure is country-specific, appropriate to local banking history, culture and politics (Haubrich, 1996; Masciandaro and Quintyn, 2008).As was also mentioned by Smith (1971) in the context of choosing free banking or central banking, the choice is not a factor of economy but more a combination of historical incidents and political motives. Here politics refers to bureaucratic politics (Allison and Zellikov, 1971), which infers that a decision is made based on a process of negotiation and compromise, avoiding a conflict of interest between political players comprised of government officials and legislators.

This study observes bank supervision policymaking, the policymakers and their scope of influence in order to investigate in more detail the history of supervision in Indonesia. This study utilizing path-dependence theory (Puffert, 1996, 1999; Chiswick, 1996). In social science, path dependence means that where we go next depends not only on where we are now, but also upon where we have been. As it has recently been applied in economics, path dependence or “lock-in by historical events” means that equilibrium allocations depend on history (Arthur, 1989).

It offers what is perhaps the best expression of the alleged importance of path dependence for economics. The lock-in in path dependence is a lock-in to something bad, or at least a lock-out of something better. It constitutes an inferior economic outcome such as an inferior standard or product where superior alternatives exist, are known, and where the costs of switching are not high (Liebowitz and Margolis, 1999). Even when path dependence considered as a qualitative approach, the path-dependence effect (PDE) of bank supervision in some European countries had been empirically tested by Masciandaro and Quintyn (2008) with robust result.

In this paper, this heterodox approach states that decisions made today are inseparable for a previous decision (or no-decision) taken, which were influenced by the environment at that time. Past political decisions restrict the flexibility of current decision-makers in their choices. Data for this study is obtained from a literature review and through interviews with those involved in decision making, which is subsequently contrasted against the experiences of several countries using purpose sampling.

THEORETICAL FRAMEWORK

Role of the Central Bank and Government

In line with the theme of this research, the primary concern is the not-always harmonious relationship between politicians and the central bank. In bureaucratic politics, the central bank and ministry of finance do not always agree in terms of policymaking, and often remain steadfast in their opinions according to their respective positions. Moran (1986) stated that this difference is based on a different way of thinking between the two sides. First, the ministry of finance and the central bank have differing perspectives and provide different expertise in the formation of policy. Second, the central bank thinks within a shorter timeframe, while in the face of change the ministry of finance can apply longer-term anticipatory policymaking. Accordingly, the government must balance both perspectives in order to maximise the power of the state, besides which the government must maintain coordination and consensus building in the formation of policy. However, it should be noted that Public Choice theory states that this kind of decision-making process ultimately results in sub-optimal policy. Furthermore, we will look at how a central bank is formed.

The formation of central bank -a 20thcentury phenomenon- is based upon a decision taken by the government, which bears special privileges and responsibilities. The central bank acts as a banker for the government and as the bankers' bank, and is given the right to issue paper money (legal tender). The choice between a free banking system and central banking system is not an ideological one but more a combination of political motives and historic incidences rather than well considered economic principles. During the 1907 banking crisis, the US embraced a free banking system. This crisis was overcome due to the role of banker JP Morgan, who coordinated liquidity assistance to the banking system (Brunner and Carr, 2007). Conversely, the banking crisis of 1933 was irreversible due to a lack of coordinated efforts to supply liquidity to the banks in trouble, which triggered nearly 2,300 bank defaults (Wicker, 2000). These two crises triggered a reorganisation of Federal Reserve Banks in 1933 to become the US central bank.

The global crisis in the1930s and World War II decimated the global economy. The private sector had insufficient resources and the capital market had not recovered. In response to this situation the state had to take control in terms of developing the economy, with a fiscal policy that could stimulate domestic demand in line with Keynes' school of thought which was fashionable at the time. Regarding domestic funding shortfalls, the government looked to the central bank for assistance in funding domestic development through the provision of credit. Under such urgent circumstances, whether the central bank should capitulate to the government or remain independent became an academic and practical question. In 1953, the first governor of Bank Indonesia and ex-minister of finance, Syafruddin Prawiranegara, stated that the central bank should remain independent of the government.

It seems that he wished to apply the accepted Western pattern because he wanted to change the position of De Javasche Bank-DJB-, which had been part of the government under colonial rule, to an independent central bank for an independent country. This wish was unrealised due to political pragmatism outweighing political ideology. One question that remains is whether Syafruddin would feel the same if he were still the minister of finance rather than the governor of the central bank, like the political aphorismof Don Price: where you stand depends on where you sit (in Allison and Zellikow as cited in Moran, 1986). This is the essence of bureaucratic politics.

Experience of Other Countries

As a comparison concerning the importance of history, incidents, culture and politics in terms of the form of bank supervision chosen, the banks will be reviewed along with the bank supervision function in France, UK and US. The history of banking in Britain will serve as an example of the difficulty of changing an esoteric banking culture. France will illustrate a choice based on the strong role of the government in the economy, and US will encapsulate the complexity of supervising a diverse financial market, which is the result of government responses to economic change. In essence, according to Coleman (1996), France applies a rather comprehensive and anticipatory strategy of action, the UK takes a reactive approach, while US has more difficulty in finding a unified strategy of action and ultimately ends up with no strategy at all, or with competing strategies implemented by different state institutions (for a description regarding US, refer to the journalistic review of Martin Mayer: The Fed, 2002).

French

Through bank nationalisation in 1945 and 1982, the Government of France applied a financial system that steered banks towards serving the goal of industrial policy and protected banks from foreign competition. During the 1960s the capital market remained underdeveloped, therefore the government focused on bank credit to finance development. The French economy became an *economie d'endettement* or overdraft economy (see Loriaux, 1991). The government's industrial policy was implemented through a system of dirigisme where the government allocated credit with lenient conditions to industrial sectors it wanted to develop. Banks segmented according to the industry to be allocated credit, with a complex supervision structure *(encadrement du credit)*.

Since reformation in 1984, the government has implemented the supervision of banks and financial companies according to a functional approach in three guises, namely :a) The control of banking activities by two organisations under the Minister of the Economy and Finances and the Governor of the Banque de France; b) The control of bank solvency is carried out by the *Commission bancaire* (banking commission); and c) The function of lender of the last resort (LoLR) is held by the Central Bank. The Ministry of Finance allocates banking licenses.

In addition to the central bank and other commissions, France also requires an interest association, banking association and financial body association to participate in supervising their respective industries. On a second level, the government informs the attentive public through a confederation of professional associations and central organisations known as The French Association of Credit Establishments (banks) and Investment Establishments. It enables the collective interests of credit establishments to be taken into consideration by government bodies and ensures that the public as well as its members are kept informed. This structure reflects the efforts taken to ensure that actors and potential actors share a common policy focus (Prossin Coleman, 1986).

Additionally, in January 2010 the government reformed the supervision function by establishing a Prudential Supervision Authority (ACP) consisting of a combination of licensing agencies and supervision authorities for banks and insurance companies. ACP falls under the auspices of the central bank and is chaired by the governor of the central bank with the vice chairman representing industry and consumers. The minister of finance appoints the secretary general and employee status adheres to central bank regulations with a budget funded by contributions from the institutions being supervised and an additional contribution from the central bank if necessary.

France is an ideal example of policymaking theory where all government actors coordinate with the central bank in order to supervise the banks, and the attentive public forms part of the policy community. Such institutional arrangements, where the government increases its power and isolatesitself from the legislature, are possible due to strong government principles based on civil law (Napoleonic law). Bureaucratic unity is tied to the filling of bureaucratic positions from graduates of the *Écolenationale d'administration or ÉNA*, where a strong civil duty is instilled. In addition, the powerful central bank has a recruitment process and career path that imbues its culture and *esprit de corps*.

Consequently, even when employees leave the central bank to fulfil other positions they take that culture with them that ingrains a sense of unity with the government, as reflected by the system of regulation and supervision imposed on the banks and financial service industry.

United Kingdom

The industrial revolution in Britain was not financed by commercial banks that only provided short-term loans, but by the capital market and merchant banks. By the end of 19th century, banks were marginal to domestic manufacturing investment while British merchant banks dominated global finances. Historically, bank ownership was concentrated in just a few hands, and competition among banks was considered to endanger prudent judgement. "Profit padding" became commonplace due to the barriers to entry (Stigler, 1971) into the banking industry, which led to a banking community in Britain socially characterised by esotericism that differed from other industrial communities. The esoteric community consisted of a closed society, run in a club-like fashion with issues resolved informally and technically. As a result of such characteristics, in their operation banks were a cartel. Bank supervision performed by the central bank was unduly loose; regulation was an exchange between partners, not an exercise in authority from the government. Politeness in language was the norm, such as quantitative and qualitative "guidelines" that were issued by the central bank on request, not as directives or instructions. The spoken word was above the written agreement and the power of trust above the force of law (Moran, 1986: 15).

The central bank worked separately from the government and the relationships between these two institutions was merely based on personal contact. Furthermore, such communication was infrequent. Supervision was not directly conducted for an individual bank but for discount houses that acted as intermediaries if the banks required liquidity assistance from the central bank. The norm began to change after the First World War, when the government began trying to open up the closed bank community and enable them to allocate credit according to government programs, which ran during WW II, by setting controls on lending. Further reforms to open up came with Competition and Credit Control in 1971, which aimed to remove controls on bank lending and to permit the price to function efficiently in the allocation of credit. On the other hand, a change in the atmosphere of the financial industry was bolstered by regulations and new players entering the industry began to undermine the esoteric banking community.

A crisis struck in 1974 stemming from mortgage defaults, which were a new kind of finance offered by the banks. The crisis began as an economic failure; however, several observers have speculated that it was more than that it was a failure of supervision and regulation. Moran (1986) cites three reasons: first, central bank incompetence to prevent the crisis due to its inability to gatherintelligence and maybe also because England had never experienced a crisis, which compared to other countries, meant it was negligent in terms of crisis prevention. Second, complexity in its banking law destroyed the privacy and informality of the banking community. And third, fragmented supervision between the central bank and the Chancellor of the Exchequer caused a problem of communication, control and coordination between them and even inside the respective institutions themselves.

Rivalries between the institutions intensified the problem of communication and coordination. In 1991,the failure of the Bank of Credit and Commerce (BCCI) coupled with the collapse of Barings Bank four years later saw the Bank of England accused of making erroneous regulations and not practicing prudential supervision. Since then the most common school of thought has argued for a separation of supervision from the central bank. When the Labour Party took control of Parliament in 1997 they formed the Financial Services Authority (FSA) with wide-ranging powers and responsibilities, including licensing as well as conducting prudential supervision for all banks and financial institutions. The bank examination unit moved as a whole from the central bank to the FSA.

Therefore, the regulatory and supervision structure was integrated in a tripartite system made up of the central bank, the Treasury and the FSA, with the ministry in charge. The Tripartite is responsible for the overall structure of regulation, decision-making and dealing with Parliament. The longstanding plan for the formation of the FSA has been full of controversy and strife behind the scenes. The FSA was considered a light-touch regime because, according to tradition, banks were more oriented towards the Bank of England not the FSA. In 2007, the FSA faced a moment of truth after failing to cope with the failure of Northern Rock Bank. The FSA became the scapegoat not the Tripartite. Here, factors of communication, coordination and responsibility in the tripartite institutions caused delays in anticipating and overcoming the crisis. Ultimately, in 2008 the FSA was disbanded and the Bank of England took over bank supervision again with the government forming a new institution to oversee business conduct and legal enforcement in the financial field.

United States

Regulating and supervising financial institutions in the US is highly complex and has an array of overlapping institutions. Any single firm might have to answer to several regulators depending on the scope of its business. At the national level, three agencies supervise the banks: First, The Federal Reserve System (the Fed) has all the traditional trappings of a central bank, namely lender of last resort as well as management of the payment and fiscal agents to the Treasury Department. It is directly involved in the supervision and regulation of member banks. Second, the Office of the Comptroller of the Currency (OCC), which was formed before The Fed was established, is below the Treasury Department. It is charged with bank licensing and bank closures. The OCC also supervises the domestic operations of such banks. Third, the Federal Deposit Insurance Corporation (FDIC), supported by insured banks, is tasked with supervising banks that are not members of the Fed system. In addition, at the state level the State Banking Commission also conducts bank supervision. These three national bodies are independent and divide their power, thus avoiding concentrating their power against the government. They are responsible to both the president and the Congress to reinforce independence and resist political pressures. When facing a financial crisis, the Fed and FDIC take the lead to intervene and ensure stability.

The US financial structure is a product of many social, political and economic factors. From the outset, the US industrial policy had pragmatism on the one hand to counter the dominant force of Britain’s industry, however, on the other hand it feared concentrated financial power and a preference for market competition. In addition, there were fears that money from local farmers would be sucked away by the industrialists, hence banking licenses would only be given in one state, even if the state forbade intrastate branching (McFadden Act 1937).The crises of 1907 and 1930 forced the government to introduce financial reforms with a double objective: to protect the banks and prevent financial conglomerates. This was achieved by limiting the number of banking licenses and types of bank business, setting an interest rate ceiling and separating commercial and securities activities. The Glass Steagall Act of 1933 separated these two activities with a firewall and insulated banks from competition with the banks' freedom to take risk through geographical borders and barriers to entry, in addition to limiting bank risk with the interest rate ceiling.

In the 1960s, price and interest rate stability began to deteriorate due to a volatile inflation rate and customer sensitivity to yield spread on their savings. Financial firms strived to release themselves from the regulations that constrained their operations. Commercial banks played a smaller role due to regulatory burdens and with such protective regulations the banks gained excessive advantages but could not readily adjust to new competition (Edwards 1996). The regulations that emerged in 1933 were intended to protect them but now prevented free movement against non-bank institutions (including shadow banks), which conducted intermediation activities but were not subject to the same requirements as banks.

Efforts to free themselves from the state banking system and the firewall Glass Steagall Act were redoubled because the banks wished to participate in universal banking that encompassedcommercial banking, insurance and securities. In 1991, intrastate banking was permitted and in 1994 interstate banking was licensed. With its promulgation the Gramm-Leach-Bliley Act of 1999 repealed financial segmentation that began in 1933. The Act also determined that the Fed will be the umbrella supervisor of financial holding companies that own the national banks, securities houses, insurance companies and much more, however, its regulatory structure would remain largely institutional. Political observers like Coleman view the reforms in the US as narrow in focus and ultimately directed at a particular crisis.

Indonesia

During colonial times the task of the central bank (more accurately the issuing bank) was given to De Javasche Bank, a semi-private commercial bank. DJB operated its monetary function based on government directives that aimed to synchronise the economy of the colony with the economy of the Netherlands. All operating revenues were obligatorily transferred to their respective head office in Holland; therefore, the banks only executed the orders of their head office, including requests for liquidity assistance as necessary. Banks in the Dutch East Indies were more inclined to request assistance from their respective head office rather than DJB because DJB was also a competitor. Bank supervision by DJB was rarely conducted, normally only as a formality. As found by Stephani (cited by Ali Wardhana in Glassburner, 2007) DJB employees were not educated nor did they strive to become central bankers.

When the Netherlands finally recognised Indonesia's independence at the Round Table Conference in 1949, in order to protect the interests of the Dutch economy in Indonesia, DJB was restored as the central bank of Indonesia, with the Indonesian-established Bank Negara Indonesia becoming a development bank. DJB was then nationalised in 1953 with Bank Indonesia (BI) as its new name. In the absence of development costs, the government required BI to allocate credit, thus, BI not only provided short-term liquidity assistance to banks but also allocated credit to the government as well as government institutions.

The economy of Indonesia was really, in essence, an overdraft economy according to Hicks (1971), hence, bank supervision by BI still called for the supervision of credit, as stipulated in Government Regulation no. 1/1955 dated 15th January 1955 based on article 7 paragraph 5 of the Bank Indonesia Act 1953.The climate of bank supervision at that time was still marked by esotericism as reflected by the explanation accompanying the BI Act 1953, which states that: "supervision is to be conducted in a manner of *understanding* between BI and the banks where BI can *request information* and BI may provide *suggestions* regarding developments in the financial and monetary fields" (emphasis in the original). The BI Act also includes the establishment of the Monetary Board as policy makers chaired by the minister of finance and with the governor of BI as a member.

As previously mentioned, we assume that the establishment of a Monetary Board is motivated by the desire to protect monetary policy from political pressures and financial exigency from the government but at the same time prevent BI from becoming independent from the government. The government argued that in underdeveloped countries, monetary policy, together with budget and fiscal policy, must become an instrument of public policy. Consequently, BI policy must be synchronised with government policy. By law BI is permitted to disagree with government policy, however, disagreements have never occurred because the cabinet can reject them if the problem is against the public interest. In reality the cabinet is the highest monetary authority in Indonesia (Wardhana, 2007) and BI merely executes the monetary policy chosen by the government, therefore, BI is subordinate to the politicians.

The conflict between BI and the ministry of finance was largely invisible to the public; hence in 1959 the public were surprised when the governor of BI stepped down after the finance minister implemented rupiah devaluation. The standing of BI took a further knock when the governor of BI was appointed deputy minister of the central bank in 1964, thus cementing BI's position as part of the government. This situation was exacerbated when President Sukarno overlooked economic problems and prioritised politics. BI as a part of the government could not prevent large-scale expansionary monetary policy, which led to hyperinflation at the beginning of the 1960s.

BI supervision of banks did not proceed due to the unification of state-owned banks (1964), which was not planned in any detail and really only existed on paper. In addition were rivalries between commercial banks and the central bank as the banks now all felt equal after the unification. The main opposition came from BNI, which was supported by President Sukarno. Furthermore, the deputy minister of banking, Jusuf Muda Dalam, originated from BNI. BDN under JD Massie did not even wish to be unified because BDN desired the role of central bank, with a special focus on small private banks. This imbroglio continued right up until the end of Sukarno's presidency.

The New Order Government took a number of measures to restore the economy. BI, which had been the "government's cashier" under the Central Bank Act of1968 has its position reinstated as guardian of currency stability in order to enhance public welfare. BI was also tasked with bank oversight and given some autonomy through the Monetary Board, which set monetary policy. In the following years the minister of finance and governor of BI jointly proposed monetary policy to the president. The government successfully adhered to a balanced budget fiscal policy, consequently, since that time BI has been relieved from the task of the finance budget deficit. At that time, BI achieved a relatively high degree of independence in terms of day-to-day monetary policy management and other central bank functions.

From 1974 up until 1983 the government dealt with policy to set the credit default limit and interest rate as well as banking licenses. This policy, known as financial repression by McKinnon (1973) and Shaw (1973), simplified the bank supervision function at Bank Indonesia. It is important to note that up to 1983 the relationship between BI and the ministry of finance was harmonious, partly due to the friendly relationship enjoyed between the governor and minister of finance, which simplified coordination in the decision-making process. However, the succeeding governor of BI was deemed more junior than the minister of finance, hence, a more formal relationship ensued.

When the economy slowed due to a tumbling global oil price, the government lifted the credit ceiling and relaxed interest rate controls in order to encourage banks through freer operations. Through these measures the government reduced the role played by BI in interfering with the management decisions of state-owned banks (Cole and Slade, 1996:100).

Moving forward, banking reforms were introduced in 1988 (PAKTO 88) to improve banking institutions, insurance companies and pension funds. The government's intention to restore banking licenses to banks that had long been closed was incongruous to the stance of Bank Indonesia, which desired prudential reforms. The government wished to respond to these developments through brisk action, however, BI was more concerned with the safety and soundness of the banking system and was unwilling to take measures that might destabilize the market (Cole and Slade, 1996:110). In the subsequent years we see that bank supervision was not effective due to difficulties with BI providing sufficient bank inspectors in a short period of time. In 1991, BI issued a set of prudential banking regulations. However, their implementation was not always particularly smooth. Lobbies consisting of market actors often intervened with bank supervision; thus, at the beginning of the 1990s the director of supervision at BI was transferred because he was considered too stern while the government was encouraging the establishment of new banks. Interestingly, he was reappointed to his position after the Bank Duta crisis struck. As a result of the reforms that took place during this period, concurrency appeared in policymaking between what was stated by the technocrats who embraced reforms and the technologists who were interventionist. In order to expedite the reforms the government did not go through the protracted process of drafting and passing laws, they merely used government regulations.

The banking crisis of 1997, which rapidly spread to become an economic crisis, triggered the emergence of a new order (numerous reviews relate to this crisis, for example Pangestu and Soesastro, 2002). BI was blamed because it provided liquidity assistance to banks suffering from systemic liquidity shortfalls (Bank Indonesia Liquidity Credit or BLBI) and issued a blanket guarantee due to the absence of a deposit insurance corporation at that time. This crisis precipitated the downfall of the New Order Government. To manage the bad credit stemming from the crisis in 1998 the Indonesian Bank Restructuring Agency (IBRA) was formed tasked with containing and restructuring problem loans from the banks. In addition, President Habibie also considered the need for BI independence from the government and subsequently promulgated the BI Act of 1999, where BI was given the primary purpose of maintaining monetary stability and forming new institutions to supervise banks and non-bank institutions.

The IMF did not initially approve the plan to form OJK (Financial Supervisory Authority), requesting that the government reconsider its plans, however, the government was steadfast and ultimately the establishment of OJK was agreed and registered in a letter of intent (LOI) between the government and the IMF. It is stated that there were also pragmatic considerations at the time that this new body would accommodate the task of IBRA and also the task of the Financial and Development Inspection Authority (BPKP), which was formed by president Soeharto and would soon be disbanded. Before OJK had been established there were a number of serious and somewhat destructive lobbies between BI, the government and legislators, which delayed its establishment by more than 10 years. In the meantime, the Bank Century crisis erupted in 2008 (stemming from problems with mutual funds issued by Antaboga; under supervision by the Indonesia Capital Market and Financial Institution Supervisory Agency), which hastened the formation of OJK. One question remains, however, why did the IMF as a proponent of reform initially rejects the idea of establishing the OJK?

Lessons learned

From the experience of the countries detailed in this paper we can conclude that the socio-economic and political development of a country determines its policy options, thus, the decisions appropriate to one country are not necessarily always suitable for another country with different characteristics. One example is bank licensing, which initially was the duty of the minister of finance or a subordinate body. In France and the United States this remains the case. However, in Indonesia the task has been transferred to the central bank. Recent developments demonstrate that reforms initiated by developed countries in the 1980s, characterised by a one-size-fits-all philosophy, have not produced optimal results. Band-wagonning (Ikenberry, 1990) is not always efficient because it is not necessarily appropriate to specific local circumstances. In addition, in the face of domestic and global dynamics, the bureaucratic decision-making responses taken at any given time will not always have optimal results.

Moran (1986) evidenced various complexities in the decision-making process, namely: Intellectual complexity from the decision makers that are caught in their own bounded rationality (Simon, 1947) in terms of observing relevant information due to ever-changing data; administrative complexity as the implementation of policy falls under the auspices of many, leading to a problem of coordination; and social complexity involving the diverse perceptions of the general public to a decision. Dynamic global socio-economic development means that the usefulness of a decision is fleeting; nonetheless, the decision-making process has become increasingly protracted. Conflicts between the central bank, which is often considered to have superpower status, and politicians/government officials have claimed many scalps, usually the governor of the central bank. In Indonesia, since the 1950s at least four governors have been forced to step down, as well as in Germany. The same is often true in Latin American countries (de Krivoy, 2000).

WHY CENTRAL BANKS ARE OFTEN BLAMED

Many supervisory activities performed by the central bank are misinterpreted by the general public due to an inherent lack of transparency. One example is “honest brokering” in the resolution of problems at an individual bank by offering the problem bank to other companies. This alternative is preferred over official assistance or bank liquidation because, theoretically, it carries less risk of moral hazard and it avoids excessive negative reaction from the market. Research indicates that 10 of 15 central banks have practiced honest brokering (Healey, 2001; see also Goodhart and Shoemaker, 1995; Santomero and Hoffman, 1998; Hougart and Soussa, 2001). Notwithstanding, this business practice does arouse public suspicion because bank inspectors are seen to be associated with the failed bank, as was the case with Bank Century in Indonesia and was also experienced in South America as noted by de Krivoy (2000). In addition, it may lead to protecting banks that should otherwise be closed merely to safeguard the name of the supervisor, which can affect the efficacy of monetary policy.

The central bank, as a bank supervisor, is criticised for its surveillance, prevention and crisis resolution in the event of a deep crisis. In Indonesia, the Monetary Board and Ministry of Finance are never be blamed, but

BI is placed squarely in the firing line. Similarly in Britain, the Bank of England was culpable during the crisis in the 1990s; but ironically during the 2008 crisis the FSA, as supervisor, was held responsible, not the Tripartite. The power of large, independent central banks causes concern for other power holders because an independent central bank is a monopolistic bureaucracy without regulatory competition that is prone to moral hazard. This raises the question: who will supervise the supervisor?

To prevent moral hazard after awarding independence to BI, the government of Habibie in 1999 also established the Bank Indonesia Supervision Board (BSBI) tasked with ensuring good governance at the central bank. Although the establishment and implementation of BSBI remains below par, looking ahead the position and authority of BSBI must be improved in order to maintain the credibility of Bank Indonesia.

PROBLEM OF COORDINATION

Supervision in USA is extremely complex, marked by inter-competition among supervisors and intra-competition among supervisory bodies to advance their own interests. Conversely, in Britain coordination is very loose because supervisors are loathed to tread on one another's toes. In France, cooperation and collaboration is forthcoming due to the principles of strong government. Furthermore, policymakers as well as executors are bound by a strong *esprit de corps*. History proves that cooperation is not always easy. From the beginning, the Monetary Board was set up to build coordination among economic institutions; therefore, officials in Indonesia are already familiar with centralised coordination. Likewise, a form of coordination initiated from an institution of equal standing would not run as smoothly.

Experience gleaned from dealing with the crisis in 1997 proves that coordination among relevant stakeholders at the specific time does not actually happen, thus, exacerbating the crisis further (Pangestu and Soesastro, 2002). It is also interesting to note another study regarding coordination at Universitas Gadjah Mada using the Prisoners' Dilemma method (Cooperative Research Team consisting of FEB UGM and FEUI 2010), for which the findings were at odds with initial estimates. Research subjects were found to be more selfish and economically oriented compared to research conducted in USA in 1991. The conclusion drawn was that coordination in Indonesia as a developing country described by Myrdal (1968) as a soft state where there is a lack of trust in members of society and an absence of social discipline is a bigger problem than initially thought.

OTHER SALIENT PROBLEMS

Other problems, which are by no means less important, include issues of cost, expertise, work culture and preparations to transfer tasks to OJK (Sukarman, 1993). Institutional costs are not insignificant. Operational costs that must be borne by the state budget will further encumber the government, unless supervision is handled by BI because BI has previously been accustomed to bearing the costs of supervision. If the costs are then passed on to the banks and financial services firms that are supervised, they in turn will see their own profits eroded or alternatively pass the costs on to their customers. Consequently, the possibility of moral hazard emerges, which can raise lending rates or lower the interest offered on deposits. The problem of work culture is a different type of issue because uniting employees from a variety of disparate institutes is not a simple task. The unification of work systems is also a significant challenge. Employee reluctance to move from their original institution is also commonplace, hence, reducing the expertise available.

Even more important is that in the implementation of the integration process is a tendency to neglect other financial developments that are incredibly dynamic and often require an immediate response. Regarding the transfer of tasks from the central bank to new institutions, we can learn from the experience of Australia during the formation of the Australian Prudential Regulation Authority-APRA- (Palmer, 2000). Impetuosity, without a phase-in period, caused a loss of corporate memory and industry expertise due to the departure of experts from previous agencies. In addition, a lack of staff in a short space of time forced the recruitment of under-qualified employees who needed additional time to master their new jobs. We have previously proposed (Sukarman, 2003) that before a new institution is established, time is required to unify the various institutions; thereby the newly formed supervisory institution will immediately be capable of operating optimally. However, ten years have passed since the inception of the idea without any administrative or legal preparations, which creates a chicken-and-egg dilemma.

CONCLUSIONS

The structural choice of supervision for banks and other financial institutions (OJK) will be made within a short period of time and depends on the bargaining position of the decision-makers. Legislators strive to clarify the mandate of the law; BI, with both good and bad experience in supervising banks, wishes to maintain its standing; and the Indonesia Capital Market and Financial Institution Supervisory Agency (BAPEPAM-LK) contrives to increase its power against other government agencies as a supervisory body. As mentioned previously, many have opined that in emerging countries, where the economy remains bank-centred (the role of banks in Indonesia remains at 85% (Abdullah, 2009)),the legal system is in the early stages of development and coordination is suboptimal, it is better that supervisory bodies are kept under the auspices of the central bank. The scarcity of human capital, coordination constraints and costs are other considerations that can be overcome if BI handles the task of supervision. BI would still have a significant role to play in any new institution because of its experience in collating financial data, its autonomous status, and its function as lender of last resort. Furthermore, the central bank can afford to attract the necessary expertise. Additionally, BI has experience as a coordinator of monetary and financial issues. However, the central bank must continually correct and learn from its mistakes in order to restore public trust and carry out its primary purpose effectively.

Recent developments in countries like France have brought about a compromise, where collegial supervisory bodies like the central bank and ministry of finance work together. In this case, the supervisory body is located at the central bank but acts autonomously with limits on its administrative affairs. For Indonesia, whichever form of supervision is chosen, it is important for all respective institutions to correct and learn from previous mistakes and seek to unite in addressing the national economy as a long-term goal. Financial instability is ever-present, therefore, we must remain vigilant to anticipate and overcome potential crises, thus avoiding another surprise like that witnessed in 1997. Crisis resolution must be performed with clear coordination among the various institutions. Independence must be interpreted in the context of recent global developments where independence is a necessity.

REFERENCES

Arthur, W. Brian, 1989, “Competing Technologies, Increasing Returns, and Lock-In by Historical Events”, 97 *Economic Journal*, 642-665.

Austin, Ian, 2001. *Pragmatism and Public Policy in East Asia*. Singapore: Fairmont International Private Limited.

Bank Indonesia, 2005, *Sejarah Bank Indone-*

sia Vol. 1-5 [The History of Bank Indonesia Vol. 1-5]. Jakarta: Bank Indonesia Unit Khusus Museum Bank Indonesia.

Berhard, William, 2005. *Banking on Reform, Political Parties and Central Bank Independence in the Industrial Democracies*. Ann Arbor: The University of Michigan Press.

Brummer, Alex, 2008. *The Crunch, The Scandal of Northern Rock and the Escalating Credit Crisis*. London: Random House Business Books.

Cihak, Martin and Richard Podpiera, 2006, "Is one Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision", *Czech Journal of Economics and Finance No.56.*

Cole, David C. and Betty C. Slade, 1996. *Building a Modern Financial System, The Indonesian Experience*. Cambridge: Cambridge University Press.

Coleman, William D., 1996. *Financial Services, Globalization and Domestic Policy Change*. New York: St. Martin's Press.

Djiwandono, J. Soedradjad, 2005. *Bank Indonesia and The Crisis, An Insider's View*. Singapore: ISEAS Publication.

Goodhart, C.A.E., 2000. "The Organisational Structure of Banking Supervision", *Financial Stability Institute BIS Basel Switzerland*. Available at http://www.sadhan.net/adls/D16/Baselcommutte/The Organisationalstructure.pdf.

Haubrich, Joseph G., 1996. *Combining Bank Supervision and Monetary Policy*. USA: Federal Reserve Bank of Cleveland.

LespeuIndonesia, 2003. *Studi tentang Aspek-aspek Advantage dan Disadvantage Lembaga Otoritas Jasa Keuangan (OJK)* [Study of Advantages and Disadvantages Aspects of Financial Services Authority Organization]. Jakarta: Lembaga Studi dan Pengembangan Etika Usaha Indonesia.

Liebowitz, Stan J. and Stephen E. Margolis, 1999, "Path Dependence", *Encyclopedia of Law and Economics, Volume I. The History and Methodology of Law and Economics*. Cheltenham: Edward Elgar. p. 985. Available at http://encyclo.findlaw.com/, accessed on May 20th, 2010.

Masciandaro, Donato and Marc Quintyn, 2009, "Reforming Financial Supervision and The Role of Central Banks: A Review of Global Trends, Causes and Effects (1998-2008)", *CEPR Policy Insight No. 30*.

Maxfield, Silvya, 1997. *Gatekeeper of Growth*. Princeton New Jersey: Princeton University Press.

Moran, Michael, 1986. *The Politics of Banking*. London: The MacMillan Press Ltd.

Ojo, Marianne, 2005, "Financial Services Authority: A Model of Improved Accountability", MPRA Paper No. 228. Available at http://mpra.ub.uni-Muenchen.de.

Peek, Joe, Eric S. Rosengreen, Geoffrey M.B. Tootell 1999: Is Bank Supervision to Central Banking? The Quarterly Journal of Economics, Vol.114, No.2 (May 1999), MIT Press. Available at http://www.jstor.org/, accessed on January 24th, 2010.

Pangestu M. and Hadi Soesastro, 2002, "The Role of IMF in Indonesia: Crisis and Recovery", in Tan Kong Yam, *Asian Economic Recovery*, Singapore University Press, Singapore.

Rosenbluth, Frances and Ross Schaap, 2003, "The Domestic Politics of Banking Regulation", *International Organization*, Vol. 57, No. 2 (Spring 2003), Cambridge University Press. Available at http://www.jstor.org/stable/3594854, accessed on January 24th, 2010.

Smith, Vera C., 1990. *The Rationale of Central Banking and Free Banking Alternative*. Indiana: Liberty Press Indianapolis.

Sukarman, Widigdo, 2003. "*Liberalisasi, Telaah Ekonomi Perbankan Masa Orde Baru"* [Liberalisation, Banking Economy-Politic in Orde Baru Area], Unpublished Dissertation, Post Graduate Programme. Yogyakarta: UGM.

Team Kerjasama Penelitian FEB UGM & FE UI 2010, *Alternative Struktur OJK Yang Optimum* [Optimum Alternative Structure of OJK], mimeograph, Jakarta, Indonesia.

Wardhana, Ali, 2007, "The Indonesian Banking System: The Central Bank" in Bruce Glassburner: *The Economy of Indonesia*. Singapore: Equinox Publishing (Asia) Pte Ltd,.