Strategies For Rescuing Banking In The Economic Crisis: A Study Of The New Institutional Economic Perspective

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Abstract: This research intends to carry out an intensive study to the public policy case for producing the strategy of banking policy formation after the monetary crisis. The methodology consists of qualitative research approach. In this research, the case study method is employed. The data are analyzed by using the interactive analysis moving ones from the data collecting, condensation, and performance, until the conclusion or verification. The result shows that the bad governance has led to unclear contract between the principal and the agent. This increases the transaction cost. The government (the principal) through the banking liberalization policy gives the big freedom to the banks (the agents) to carry out the business extensification without the support of strict supervision. This has caused the bad bank management was not detected and corrected by the central bank. In addition, the incentive structure in allocating resources does not stimulate the bank obedience to the given formal rules.

Index Terms: *banking, bank liquidity, monetary crisis, bank management, New Institutional Economics*.

1 INTRODUCTION

The unpredictable nature of the Indonesian crisis in 1997/1998 is also reflected on the description about correction of the rating agencies. When the crisis hits Indonesia on 1997/1998, there are many top rating agencies like Fitch, S&P downgrade the sovereign ratings which they give to Indonesia [1]. The description about their sovereign rating is referred by the calculation of economic and political aspects of a country. The exchange rate of US dollar to the Rupiah also sharply increases. Within a very short time, the exchange rate of Rupiah to the US dollar which was range Rp. 2,000.- on 1998 was rapidly depreciated into Rp. 3,000.- and it was continuing to weaken and in the short time dramatically dropped to Rp. 11,000.-. It is as if exchange value of Indonesian rupiah evaporated [2]. However, the newspaper and mass media recorded that the purchasing power of society was more and more decreasing; the price of basic needs sky rocketed. On November 1997, the government revoked the business license of 16 banks. It is happened the depreciation of trust to the banking that caused panic and withdrawing funds from the society that have the savings in the banks because they were worry if their savings loss [3]. The bad bureaucracy institutional gives the big impact to the quality of public policy which is formulated to handle the monetary crisis. The policy of Bank Indonesia Liquidity Assistance (BLBI) that is intended to help the banking to escape from the liquidity crisis is precisely misused by the bank owner. The banking institutional problem at least can be traced back form the report of BPK. According to the BPK report, the case of BLBI policy on 1997-1998 is triggered by the weakness of system and the negligence in BLBI deployment. The practice marred with moral hazard has caused the significant state losses amounting to Rp. 138,442,026,000, 00 or 9.58% of BLBI total allocation. Ironically, the potency of state losses is charged to the government with the duty total is in amount of Rp. 144,536,086,000.00. By using the New Institutional Economics (NIE) approach as a lens [4], this research intends to study the institutional factors that are the root of the banking system vulnerability that is revealed on 1997 and then by the end of exchange value crisis on 1998. With reference to the New Institutional Economics (NIE), this research studies what institutional factors become determinants to the case of the banking crisis. However, the handling of banking crisis is seen sub-optimal [5]. Based on the theoretical framework, it can be seen that the absence of the playing rules gives chance to the economic actor to obtain unfair profit. However, there is also analyzed how the institutional environment, governance, allocation of resources give the impact to the banking industrial design that becomes fragile on 1997/1998.

2 MATERIALS AND METHODS

2.1 New Institutional Economics (NIE)

Discourse of economic thinking back warms up since the paradigm of New Institutional Economics (NIE) developed on 1990. The appearance of NIE is for perfecting the assumptions weakness which is developed by the thinking of the Old Institutional Economics (OIE) and Neo-Classic Economics (NCE). There is the base difference among the three economic thinking [7]. The theory of OIE looks important the institution role but it is weak in the systematic of theoretical base because it is built from the caustic proves. However, the theory of NCE relies the role of market mechanism and the assumptions of the perfect information, no transaction cost, and perfect competition. The other assumption that is developed by NCE is that every market actor experiences the same situation and frees to enter the market [8]-[9]. There is difference with the approach of classic as well as neo-classic economy; the approach of NIE gives the new direction in understanding the economic science. One of the important issues that is highlighted by NIE is the transaction cost becomes as the key to the economic performance. The transaction cost is formed by the institution and institutional order like the law, politic, and social systems. According to Coase [10], the institutional factors become as the determinant

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to the economic performance. Therefore, the NIE approach becomes important in the study of economic science or public policy in economic field because it gives the big attention to the non-economic factors that determines the economic performance.

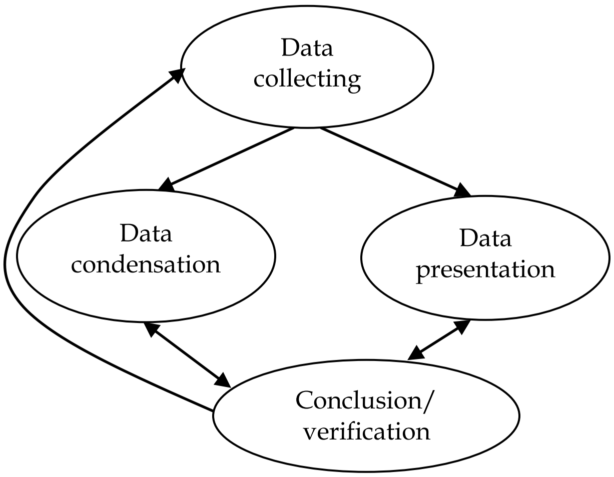

Fig. 1. *Method of interactive analysis [6]*

2.2 Agency Theory
Agency theory describes the happening of asymmetry information on the relation between the principal and agent, where the principal is as the side that employs the agent. The agent action that cannot be directly observed by the principal causes the expensive monitoring cost. Mainly the banking industry as well as generally the monetary industry is known as the most regulated industry, remembering there are many related rules for the sake of guarantee the internal stability. Especially, the banking industry is very susceptible to the institutional problem like the moral hazard, asymmetric information, and the principal agent. Reichelstein [11] said that the agent problem will be appear when a principal hires an agent to carry out a work but the agent does not follow to obtain the part of what the production. However, Stiglitz [12] presented that the problem between the principal and the agent wiil be appear when there was an imperfect information in the relation between the principal and the agent.

2.3 Regime and Outcome of Banking System
The policy of banking rescue on the economic crisis on 1997/1998 is much related with the politic system that is developed now. The authorization regime that is authorized by the new order government forms the oligarchy public policy in regulating the banking sector. Based on the definition by Winters [13], oligarchy is the behavior that dominates and controls the big concentration of material resources which can be used to hold and increase the exclusive personal wealth and social position. The type of government determines the relation of bank actor and government, the banking system and the result. With the type of oligarchy regime that is played by the new order ruler, the banking rescue policy on the crisis period describes at least the three things. First, the allocation of BLBI to some problem banks is come from the state budget that is controlled by a handful of ruling elite for giving the profit exclusively to the group. Second, the authorization and control pf BLBI budget is allocated for the personal interest of the bank actor who is close with the authorization. Third, the exclusive relation between the bank actor and government tends to cause the moral hazard due to the government control that is very weak to the bank actor.

3 Results and Discussion
The result of this research related to the factors that influence the crisis on 1997/1998 in Indonesia from the formal side, can become as the base strategy to make decision in maintaining the monetary stability as well as in relating to prevent the crisis returns. Some researches which are summarized in this research is as the analysis result of the factors that is influenced the crisis on 1997/1998 in Indonesia due to the some variables approach. Rao [13] has analyzed the background and the cause of the Asia economic crisis happening on 1997/1998. The deficit of current account that is continuously happened, does not make the countries to carry out the policy to improve their internal condition, they are complacent with the good economic performance (the economic growth is continuously increasing). Besides the deficit of trading balance, according to Rao [14], the speculation and the high short term credit ratio on the countries, makes the crisis contagious quickly. For Indonesia, it is influenced by the high credit of private sector at that time that reaches $ 58.7 milliards on the middle of 1997. It is the very high number if compared with Japan and USA that is in amount of $ 4.6 milliards. In further analysis of Rao [14], there had been happened 6 crisis that overwrite Hongkong, Indonesia, Korea, Malaysia, Philipina, Taiwan, and Thailand on 1997-1998 [15] [16]. As presented in the Table 1, from the 8 counties in the Asia, Indonesia is the worst because affected from the 8 crisis that are happened.

Table 1. *Country and 6 crisis of Asia*

Economy	Trust crisis	Exchange value crisis	Monetary crisis	Economic crisis	Social crisis	Politic crisis
Hongkong	√	-	-	-	-	-
Singapore	√	√	-	-	-	-
Taiwan	√	√	-	-	-	-
Malaysia	√	√	√	-	-	-
Philipina	√	√	√	-	-	-
Korea	√	√	√	-	-	-
Thailand	√	√	√	√	-	-
Indonesia	√	√	√	√	√	√

Source: Rao [14]

Sadly [15] in his research with the title of “The Indonesian Crisis”, analyzed the cause of crisis in Indonesia and why the crisis impact in Indonesia was worse than the other Asean countries. The result of his research showed that the factor that is influenced the crisis was the trust collapse to the short term modal and the high private credit. However, the factor that causes the crisis of Indonesia is worse than the other countries in Asia, it is caused by the politic factors, politic instability on the Soeharto’s government, the high corruption, and oppression in the whole politic opposition, and the policy recommendation application of IMF which precisely worsen the situation. Khan *et.al.* [16] in their research of “An Economic Analysis of the Causes” had analyzed the cause of crisis and distribution process to the other country (from Thailand) by using the variable approach of exchange value between countries. In this research, Khan *et.al* [17] used the correlation method before and when it happened the crisis. Table 2 presents the correlation of real exchange value between Asia countries.

Table 2. *The correlation of real exchange value between Asia countries (period: Jan 1995 – Dec 1996)*

	Indonesia	Korea	Malaysia	Philippines
Korea	0.476			
Malaysia	0.604	0.223		
Philippines	0.681	0.775	0.509	
Thailand	0.695	0.703	0.308	0.863

(**) significant on the level of 1 % LR Test static = 76.266**

Table 3 presents the correlation result of exchange value between countries before the crisis. The result shows that the exchange value on the Asia countries are not interconnected. It can be seen that there are no significant variable.

Table 3. *The correlation of real exchange value between Asia countries (period: Jan 1997 – Dec 1998)*

	Indonesia	Korea	Malaysia	Philippines
Korea	0.560**			
Malaysia	0.689**	0.848**		
Philippines	0.256	0.726**	0.699**	
Thailand	0.647	0.497	0.603**	0.811

(**) significant on the level of 1 % LR Test static = 95.257**

Table 3 is the correlation result of exchange value between countries when the crisis. It can be seen that the exchange value of Indonesia has the positive correlation with Korea and Malaysia because the exchange value variable of Indonesia to the dollar is statistically significant on the level of 1 %. The variable of Korea exchange value has the positive correlation to the Malaysia and Filipina ones.As presented in the Table 4, for the crisis case 1997/1998 in Indonesia, the variables of export, direct infestation (FDI) and the amount of money supply (JUB) has a significant effect to the crisis 1997/1998. The variable of export influences negatively to the crisis, however, DFI and the amount of money supply influences positively to the crisis. The case of banking crisis in Indonesia on the crisis period 1997/1998 provides the interesting scientific proof from the perspective theory that is New Institutional Economics (NIE). Based on the information that is obtained from the interview result and literature study, the banking crisis at that time is actually rooted from the weak institution that regulates the banking sector in Indonesia, Therefore, it creates the opportunistic behavior and the moral hazard. In the other words, the weak institutions determine the incentives for opportunistic behavior and the moral hazard. The analysis as follow is summarized the important founding based on the institutional schemes into 4 levels. However, in this study there are classified into level 3 and 4.

Table 4. *Result of Linier Probability Regression*

Country	Indicator	Coefficient	S.E.	Hypo-thesis	Foun-ding
Singapore	RIR	0.016924	0.003833***	+	+
	INF	-0.007592	0.013743	+	-
	EXPO	-0.044002	0.015313**	-	
	FDI	0.100576	0.050588*	+	+
	M2	-0.01041	0.008244	+	-
	CAB	-0.091323	0.030529***	-	-
Malaysia	FDI	0.001123	0.000639	+	+
	M2	0.000126	3.10E-05***	+	+
	EXPO	-0.005455	0.001840***	-	-
	RIR	-0.001851	0.000870*	+	-
	SDR	-0..21709	0.015975	+	-
	CAB	0.146401	0.062320**	-	+
	INF	-0.001087	0.001939	+	-
Thailand	EXPO	0.034695	0.010081***	-	+
	DOC	-0.052679	0.0012421***	+	-
	M2	0.043243	0.011080***	+	+
	FDI	0.001037	0.000602	+	+
	RIR	0.001163	0.000453**	+	+
	CAB	-0.212867	0.070734**	-	-
	SDR	0.000588	0.000455	+	+
Indonesia	INF	0.000925	0.001262	+	+
	EXPO	-0.000438	0.000235*	-	-
	FDI	0.001614	0.000880*	+	+
	M2	0.020413	0.005962***	+	+
	SDR	0.000404	0.018419	+	+
Philippinnes	RIR	0.000159	3.16E-05***	+	+
	CAB	-0.31309	0.010324***	-	-
	M2	0.024910	0.007214***	+	+
	FDI	0.000752	0.000537	+	+
	DOC	6.59E-05	2.99E-05**	+	+
	EXPO	-0.006004	0.005836	-	-
	INF	0.007065	0.005811	+	+

*,***,*** significant on the level of 10%, 5%, and 1%

Level 3 is related with the governance like contract and transaction cost. The assumption is that the banking crisis is caused by the relation of unclear contract between the bank and the central bank. In the case of banking crisis in Indonesia, the unclear contract between the principal and the agents can be seen from the 88 pact policy that liberates that the establishment of bank is not supported by the strict control from the Central Bank. The impact is there are many banks carry out the foreign loan with the short time scheme but it is high risk. The bank behavior is not well monitored by the Central bank, ironically, the Bank Indonesia as the central bank does not carry out the well documentation about the traffic and the amount of credit model on the private banks. The banking governance has opened the high risk mainly when the monetary crisis.The moral hazard in the form of foreign credit that reaches in amount of USD 78 milliards which is carried out by the private banks, is not detected by the Central Bank, When the monetary crisis impacts to the surge of USD, the private banks are on the very important position. Their debt burdens become very heavy. Besides it, the case of rush money in the customers due to the public distrust to the management of public bank, trigger too the banking crisis. To response the situation, the Bank Indonesia regarding to the IMF suggestion provides the BLBI for recovering the banks that are not liquid so the banking crisis can be controlled. However, the moral hazard is happened again because the BLBI is not used for solving the banking problem, but it is used for the personal interest of the bank owner or even it is invested abroad. Based on the discussion above, the conclusion is the bad banking governance is caused by the unclear Central Bank role in carrying out the control function to the transaction that is carried out by the bank manager. As a result, the transaction cost in the form of capital flight and non-effective BLBI for restoring the bank healthy is as the risk that is accepted by the Central Bank. Level 4 discuss the allocation of resources. Basically, this level analyzes the incentive of the stakeholders who are involved in the BLBI policy and to evaluate their obedience to the whole rules that are applied. In the BLBI case, the stakeholders consist of 54 problematic banks and Indonesian Bank Restructuring Agency (English IBRA, Indonesia: Badan Penyehatan Perbankan Nasional). The problem is appear when some stakeholders take the benefit of the violation of the rules on the program restructure. For instance, the resource allocation of BLBI should be based on the strict selection rule. However, as stated by the former official of BLBI, the BLBI should only be given to the liquidity insured banks. However, in the implementation, the insolvent banks also get the allocation of BLBI. Indeed in the crisis situation, the BPPN gets the high pressure to carry out the function and duty to recovery the bank healthy. However, the violation to the playing rule of BLBI does not really give the positive effect to the problem banks. It can be seen from the soaring on the number of debit balance banks becomes in amount of 39 banks.The violation of BLBI policy rule by BPPN indicates there is the incentive behind the problem banks participation as well as BPPN as follow:The bank incentive that follows in the BLBI policy. Long before the banking crisis happened, the condition of banks management in Indonesia is far from the good banking management. The 88 pact that is used by the private banks to extensive their business scale and foreign credit. The banking system has been opened with the external marketing, so when there is happened the monetary crisis, the Indonesian private banks have not ability to defend from the devaluation effect of Rupiah. When the bank is collapse, the Bank Indonesia as the lender of last resort has the duty to save the national banking condition. Through the BPPN, the Bank Indonesia supplies the BLBI to the problem banks for decreasing the high transaction cost due to the scheme of foreign credit with the high risk that is carried out by the national banks. The charge of transaction cost is confiscated by the BPPN in the form of BLBI liquidation in amount of 144.5 billion Rupiah. What the BPPN carries out, actually is an effort to prevent the impact of systematic financial crisis. However, in the implementation, the BLBI is used by the problem banks to get the fresh fund and then to be used not for recovering the bank healthy and public trust, but the BLBI is precisely for the other interest that is not fitted with the formal rules. However, even some bank owners have the perception that BLBI is the aid from the government so there is no responsibility for returning. In this context, the incentive from the stakeholders to follow in the BLBI is to manipulate the BLBI for their personal interest. By the end, then the BPPN has to assure the transaction cost due to the violation of BLBI playing rule by the problem banks. Incentive of the Government of Indonesia to build the BPPN and to deploy BLBI. The issue of asymmetrical relation between Bank Indonesia (BI), BPPN, and the acceptor of BLBI is described by the principal agency. The essence of agency theory is that the hierarchy system regulates the delegation of responsibility from the principal to the agent. However, the interest of the principal sometime differs to that to the agent. In this case, BI is the principal, however, BPPN and BLBI acceptor is the agent. In reality, the agent has the significant discretion so it cannot be fully monitored by the principal. That is then creating the asymmetrical relation between the principal and the agent. The agents with their knowledge can work out of what to be instructed by the principal. It is then causing the tension between the agent that has the discretion and interest, and the principal that makes effort to carry out the function and the organization interest, and to monitor the agent activity. In the context of BLBI, the BI interest to build the BPPN is to supervise intensively the bank that is supervised and to manage the problem bank asset. There are 54 problematic banks that are supervised by the BPPN that are 4 government banks, 23 division private banks, 14 no-division private banks, 11 regional development banks, and 2 mixed banks. The hope is that the authorization delegation of supervision from BI to BPPN is to recovery the problem banks quickly and efficient. In the implementation, BPPN is precisely fail to return the public trust to the problematic banks. The impact is BI supplies the BLBI as the last gun to fulfill the systemic risk to the national bank. However, the BLBI is also fail to bring to recovery the national bank back to healthy. This failure is sourced from: 1) the weak capacity of BPPN in carrying out to monitor the banks of BLBI users; 2) the accountability of BPPN in developing the responsibility is low; and 3) the government and elite intervention to the work of BPPN so the BPPN does not work independently and professorially in managing the problematic banks asset and to supervise the allocation of BLBI.Therefore, the banking crisis is due to the problem complexity that revolves around lack of clarity of authority, lack of clarity of ownership, contracting, and inappropriate incentive structures. The interview result with the Bank Indonesia senior official revealed that the allocation scheme of BLBI that has been approved by IMF evidently is not supported by clarity of criteria on bank selection that defines which bank should receive assistance and why—i.e. which bank is illiquid, which bank is insolvent, etc. As a result, the allocation on the BLBI source of fund does not fully lead to the intended positive effect to the recovery of the problematic banks. Therefore, it can be concluded that the weak incentive structure causes the ineffective government policing, further aggravating the banking problem.

4 Conclusion

Based on the research result and analysis of research founding, it can be concluded as follow: The bad governance has caused the unclear contract relation between the principal and agent, and increasing the transaction cost. The liberalization of banking on 1988 is not supported by the governance of strong and accountable banking sector. The government (the principal) gives the big freedom to the bank (the agents) to carry out the business extensification without the supporting of strict and capable supervision system. It has caused the bad bank management, practice to escape undetected by the central bank's supervision. As the result, the private bank that is managed by the weak banking management system is out of control from the Central Bank. However, the bad management quality in the banking sector gives the negative impact to the BLBI aid. Ideally, the BLBI can help the banks back to recovery, but in the implementation, it is precisely perverted by the bank for the owner interest. The incentive structure in the resources allocation does not stimulate the bank obedience to the formal rule. Indeed banks' deviation in following restructuring strategy and deviation of BLBI usages are intertwined with the weakness of the formal rules and the weakness in enforcing the rules when deciding and monitoring the acceptors of the liquidity assistance. The intervention of bureaucracy and politic to the BPPN has caused the allocation of BLBI is not supported by fair and correct selection criteria. By the end, there are much violation are carried out by the banks as the BLBI acceptor. The violation indicates that the problematic bank's incentive in following ther BLBI policy is to obtain the fresh fund and to manipulate for their own interest, which differ from the BLBI policy's intended goal.

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