

Review Article

History of Islamic Bank in Indonesia: Issues Behind Its Establishment

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Abstract: This paper aimed at making a critical review of the history behind the establishment and development of Islamic bank in Indonesia. This review revealed that the establishment of Islamic bank in Indonesia emanated from the undertowed and it's divided into three phases. These phases are the phase of idea or thinking, the phase of rethinking, and the phase of established and maturation. The main issues and problems that inhibited the establishment of Indonesian Islamic banks were political issues, lack of government support, legal issues, social problems, economic problems (lack of capital) and the debate among scholars about the legal prohibition of halal-interest conventional banks. These issues and problems delayed the establishment of Islamic bank in Indonesia.**Keywords:** Indonesia, Islamic Bank, Bank History, Bank Establishment

1. Introduction

The existence of modern banking institutions that operate under Islamic system is still at its early stages compared to the conventional banking system that existed about 420 years ago. Establishment of a conventional bank called Banco della Pizza in Rialto, Venice in 1587, followed by the establishment of a modern bank in the UK in 1694 were the starting point of modern banking world (Sumner, 1971; Hamoud, 1985).

The establishment of financial institutions without interest as a landmark of Islamic bank was tried in the mid 1940s in Malaysia, but was unsuccessful (Erol & El-Bdour, 1989). The existence of modern Islamic bank commenced with Bank MYT Ghamir founded in Egypt in 1963. Bank Islam MYT Ghamir was closed in 1967, but the attempt inspired the establishment of other Islamic banks (Haron, 2005). It is believed that the establishment of Bank Islam MYT Ghamir paved the way for the establishment of Islamic banks. In the 1970s, Islamic banks grew and developed in number and size

(Metawa & Almosawi, 1998). Besides the government, the private sector also contributed to the development of Islamic banks. The first private Islamic bank called Dubai Islamic Bank was established in 1975. In the same year, the International Development Bank (IDB) in Jeddah, the Faysal Islamic Bank in Egypt and Sudan, and Kuwait Finance House in Kuwait were established. By the early 1980s, Islamic banks have also emerged in non-Muslim countries like Europe, America and Australia (Ebrahim & Joo, 2001), and thus the acceptance of Islamic banks by the world was encouraging. Wilson (1994) reported that Citibank (one of the largest banks in the US), HSBC (in Hongkong) and ABN AMRO (in the Netherlands) have opened *Islamic bank window*.

Islamic bank in Indonesia was established in 1992 through the establishment of Bank Muamalat Indonesia (BMI). The establishment of Islamic banks in Indonesia is considered late as compared to other Muslim-majority countries such as the Philippines (1973) and Malaysia (1983). Ariff (1998) stated that delays in the establishment of Islamic banks in Indonesia was due to lack of support from the Muslim community and

the government (lack of political will). Chapra (1987) and Haron and Yamirudeng (2003) also reported that, the development of Islamic bank in a particular economy is influenced by the support of Muslims and the government.

Efforts for the establishment of Islamic bank in Indonesia began before the Second World War (Rahardjo, 1998), but it was not until the 1990s that Islamic bank was established in Indonesia. The main questions one would ask is that, what led to the delays in the establishment of Islamic bank in Indonesia? What issues prevented its early establishment? How can these issues be resolved? The objectives of this review are to provide information on the establishment of Islamic bank, the struggle involved in the establishment of Islamic bank and the latest developments in Islamic bank in Indonesia.

Methodology

Literature on Islamic bank with emphasis in Indonesia was reviewed. Secondary data was obtained from Bank of Indonesia official reports, refereed journals, postgraduate theses and conference papers. There was inadequate published data and articles related to Islamic banks in Indonesia. This is because not much researchers in Indonesia have published their study in English and are online (internet). This paper provides an overview of the history of Islamic bank in Indonesia, from its inception to recent developments.

2. Brief of Indonesian Structure

Indonesia is the fifth most populous country in the world with a population of around 237 million of which about 204 million (ca. 86 percent) are Muslims (BPS, 2015). Indonesia is the largest Muslim nation in the world. Although majority of Indonesians are Muslims, Indonesia is not an Islamic state. According to Ariff (1988) and Wouters (2007) Indonesia is a country with an ideology of Pancasila and basically shows the character of a secular state, with the monetary system as a capitalist country. The Muslim population in Indonesia is divided into two main groups; these are *Abangan* and *Santri*. *Abangan* also known as Islamic by Identity Card (*Islam KTP*) refers to Muslims who do not practice Islam. In terms of the daily life they are Muslims merely and only by identification card (IC). *Santri* follow Islamic values in their daily lives. According to Ariff (1988), *Santri* are also fragmented into two parts. First is the elit or reformist *Santri*; those who are usually highly educated, modern and live in urban areas. Second is the fundamentalist or traditional *Santri* with educational background in traditional system and live in villages or *pesantren* and are likely conservative.

3. Establishment of Islamic Banking

Issues related to the establishment of Islamic bank in Indonesia can be grouped into three phases. The first phase is the phase of thinking, the second phase is the phase of preparation and establishment, and the third phase is the phase after formation (maturation of the concept and setting).

First Phase (Phase of Thinking)

The first phase of the establishment of the Indonesian Islamic bank began in the 1930s. This phase was known as the phase of thinking or theoretical. This happened at the time Indonesia was colonized by the Dutch. This was the most difficult time in the establishment of Islamic bank in Indonesia because of the uncordial relationship between the Government (the Dutch) and Muslims. The extreme Islamic movement or Islamic fundamentalist group made the first attempt towards the establishment of Islamic bank in Indonesia. K. H. Mas Mansur, one of the *ulama* (Muslim scholars) and head of *Muhammadiyah* organization, was the first person to conceive the idea that Islamic bank should operate without benefit/interest system. His idea elicited reactions and debates among *ulama* and leaders of the socialist such as Muhammad Hatta. The socialists justified that the interest of conventional banks is voluntary between the two sides, there is no element of extortion or coercion, has a function in the public interest, and the amount required is not large (Rahardjo, 2002). K. H. Mas Mansur pioneered and championed the course that the interest charge by conventional bank is illegal (*haram*) because it is required by the contract and the existing of extortion (Rahardjo, 1998; Karim, 2001). Then came the third opinion of the 'gray' (doubtful) or in the middle between "legal (*halal*) and illegal (*haram*)". According to this opinion, the amount and condition of the interest can be legal, but in other situations it can be illegal (Rahardjo, 1998). Indonesians first vice President (from 1945-1956) did not support the establishment of Islamic bank. This contributed to the negative response from the community and government towards the establishment of Islamic bank in Indonesia. The issues of halal-haram/legal-interest conventional banks that led to the slow growth of Islamic bank still exist among Muslims in Indonesia (Mukhlis, 2011).

Islamic bank was only discussed theoretically among *ulama* and Muslim intellectuals until 1960s. There were no real measures and clear plans for establishing Islamic bank, despite this, it has emerged as one of the solutions to economic problems and has improved social welfare of many Muslims (Sutedi, 2009). Publishing books and papers on Islamic economics especially on interest-free loans gain more interest during this period. Most writers of these books were the instigators of forward-thinking Islamic party associated with the Muslim Brotherhood movement in Egypt.

Legal issues were also hindrances to the establishment of Islamic bank in Indonesia. The Indonesian banking practices supported by the law No 14 of 1967 on banking states that, every bank in Indonesia must operate based on interest. In 1968, the Islamic organization called Muhammadiyah opined that the 1967 law was unclear and the interest stated is allegorical. According to Antonio (2005), the Muhammadiyah tried to establish banking institutions in accordance with Islamic rules. In 1969, the fight to establish interest free Islamic banks intensified following a conference held by the Organization of Islamic Countries (OIC) in Kuala Lumpur (Sudarsono, 2005). As a result of this conference, the Islamic Development Bank (IDB) was established in Jeddah in 1975 and Indonesia was one of the countries involved in its

establishment (Admadja & Antonio, 1999). This encouraged and motivated Indonesia to establish its own Islamic bank to improve upon the economic empowerment of Muslims.

The need for Indonesia to have more Islamic banks also received attention among Muslim intellectuals. Various attempts including the introduction of Islamic economic courses at the universities and the creation of a non-political organization oriented towards economic development of Muslims were made to increase the establishment of Islamic banks in Indonesia. Nevertheless, the establishment of Islamic banking is still at the theoretical framework, despite the change of leadership from the Old Order (ORLA) to the New Order (ORBA). ORBA authorities continued to link the establishment of Islamic banks to the promotion of an Islamic state (Karim, 2007). Islam has been developed solely for the exercise of worship and religious ceremonies. Islam as an ideology of life, have no place in the constitutional system of Indonesia. All these, together with lack of commitment from Muslim community's and support from the government delayed the establishment of Islamic bank in Indonesia.

Second Phase (Preparation and Establishment Phase)

In the 1980s, the Indonesian Muslim intellectuals and *ulama* re-visited the idea of establishment Islamic banks in Indonesia. Their desires were ignited by seeing the success of Malaysia and other Muslim countries in setting up Islamic banks, but their efforts failed because of the political situation that followed suit. At that time the government tried to impose Pancasila as the sole foundation of all social organization. Any idea that has to do with the word "Islam", including Islamic bank does not have the support of government (Yasin, 2010). The phobia for the word 'Islam' by the government in relation to the creation of an Islamic state linked with Islamic extremism and fundamentalism hampered the establishment of Islamic banks in Indonesia.

In 1982, the relationship between Indonesian government and Islam slightly improved. New Order (ORBA) government began to lose the support of the Indonesian Armed Forces (ABRI) and this forced the government to gain support and legitimacy with non-ABRI such as the *ulama* and Muslim intellectuals. The government showed open attitude towards Islamic organizations. By this, lots of concessions were granted to Muslims in an era referred to as the political accommodation for Islam (Salim, 2004). This era was exploited by *ulama* and Muslim intellectuals to re-submit the idea of Islamic bank which they have been fighting for. Within this era, there was also an increased in the quality of education of Muslim intellectuals (educated abroad). The government felt the need to listen to opinions, voices and wishes of Muslim intellectuals. This contributed to an increased bargaining power for Muslims for the establishment of Islamic bank in Indonesia (Effendy, 1998).

In October 1988, the Indonesia government issued a policy package (PAKTO) on the liberalization of the banking industry which stated that, banking can be established at 0% interest. This policy paved the way for the establishment of Islamic banks that operated on interest-free principles. After the government gave the 'green light' for the establishment of

Islamic banks, another problem which has to do with startup capital surfaced. Partial support from the government made it difficult to raise the needed initial capital for the establishment of Islamic banks. Various efforts were made by Muslim communities and intellectuals towards raising funds as seed capital for the establishment of Islamic banks. The Indonesian Muslim Intellectuals Association (ICMI) led by Prof. Dr. B. J. Habibie (Indonesia Minister of Science and Technology from 1978-1998, Vice President in 1998 and President between 1998-1999) played a positive role towards the contribution of funds for the establishment of Islamic bank in Indonesia. For a start, Islamic banks were established on a relatively limited scale and localized. Islamic banks like Bait-At-Tamwil at ITB, Bandung, Cooperative Rhido Ghusti, Jakarta and Bank Perkreditan Rakyat Syariah or Credit Shariah People Bank (BPRS) were established (Sutedi, 2009).

Movements to intensify the establishment of Islamic banks in the country began in 1990. In this year, Indonesian Muslim Council (MUI) held a seminar to discuss the bank interest issues. As a result of this seminar, it was agreed to establish interest-free Islamic banks. The seminar was followed by the National Congress of MUI where it was decided to form a working group to complete preparations for the establishment of Islamic banks. The working group was called MUI banking team and the team was given the responsibility to conduct preparations related to the establishment of Islamic banks with consultation with all concerned parties (Admadja & Antonio, 1999; Antonio, 2001).

After all the issues above related to the establishment of Islamic banks addressed, the problem of the name to be used arose. ORBA under the leadership of President Suharto still had an issue with the use of the word "Islam" because of the potential issues associated with fundamentalism and the concerns that it will cause inconvenience to the people of Indonesia, since Indonesia consists of people of various religion and ethnic groups (Triyuwono, 2000). Thus Islamic banks were tasked by the government to work with caution. Besides the non-Muslims, there were Muslims who opposed the idea of using the word 'Islam'. There were also some groups that have always linked the establishment of an Islamic bank with an extreme religious issues and suspicions of the establishment of an Islamic state. Islamic bank teams continued to work diligently to adapt appropriate measures to convince the parties who were in disagreement with the use of 'Islam' in Islamic banks (Hidayati, 2005). The efforts of these teams made the Government of Indonesia to establish the 1991 Act to approve the establishment of Islamic banks in Indonesia. In 1992, the Bank Islam/Shariah in Indonesia, currently known as Bank Muamalat Indonesia (BMI) began operation with an initial capital of Rp 84 billion (Ariff, 1996).

Third Phase (Maturation of the Concept and Setting Phase)

This was a unique phase in the establishment of Islamic banks in Indonesia which took place from 1990 - 2000. At that time only one Islamic bank that is the BMI was established. This bank was a trademark for the economic revival of Islamic banks in Indonesia and thus the history of the establishment of Islamic banks in Indonesia cannot be emphasized without

noting the role played by BMI (Yasin, 2009). In 1992, the Indonesian government issued the law No. 7 of 1992 on Indonesian banks. In law No. 7, the term Islamic bank was not explicitly stated, it was expressed as "bank based on the principle of sharing". This law was a legal framework for Islamic bank operations in Indonesia. From 1992-1998 BMI was the only commercial bank based on Islamic principles in Indonesia.

In 1998 the government amended the law No. 7 of 1992 and replaced it with the law No. 10 of 1998. This law provided stronger legal basis for the establishment of the Islamic banks in Indonesia. In law No. 10 the term "bank based on the principle of sharing" was changed to "bank based on the

principle of Shariah" or abbreviated as "Shariah bank" (the official term for Islamic banks in Indonesia based on law No. 10 of 1998). In the law No. 10, Shariah banks were allowed to operate under dual banking system. The dual banking system allowed Shariah banks to operate on both interest and interest-free bases. This opened up vast opportunities for conventional banks to offer addition Shariah products while retaining their conventional systems. Thus eventhough Islamic bank in Indonesia was established by law No. 7 in 1992, the development of Islamic bank was significant only after the enforcement of law No. 10 of 1998 (Rae, 2008; Bank Indonesia, 2002). Phases of establishment and development of Islamic banks in Indonesia is summarized in Table 1.

Table 1. Phases of establishment and development of Islamic bank in Indonesia.

Phase/ Year	Development	Actual Action
I/1930-1980	Thinking Phase	Emerging ideas coming in to establish Islamic Banks
II/1980-1990	Rethinking	Blowing ideas and rethinking to establish Islamic Banks. Publishing books, journals, teaching of economic Islamic subject in universities as introduction step to the establishment of Islamic banks.
	Preparing Phase	Significant actions to prepare for Islamic bank establishment: i.e. successful lobby to government to get permission and funding (capital)
III/ 1990-2000	Establishment	Bank Muamalat Indonesia (BMI), first Islamic bank successful established. Law No. 10 in 1998 on Islamic bank issued by government.
	Post Establishment (Maturation of concept)	

Table 2. Development of Islamic banks in Indonesia in 2003-2015.

Banking indicators	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Islamic banks (unit)	2	3	3	3	3	5	6	11	11	11	11	12	12
Islamic banking units (unit)	8	15	20	20	26	27	25	23	24	24	23	22	22
Total number of offices (unit)	299	401	504	531	597	822	998	1477	1737	2271	2588	2483	2301
Total deposit (trillion Rp)	5.8	11.9	15.5	20.7	28.0	36.8	52.2	76.0	115.4	147.5	183.5	217.9	231.2
% growth deposit	-	105.2	30.3	33.5	35.3	31.4	41.8	45.6	51.8	27.8	24.4	18.7	6.1
Total financial (trillion Rp)	5.5	11.5	15.2	20.4	27.9	38.2	46.9	68.2	102.7	147.5	184.1	199.6	213.0
% financial growth	-	109.1	32.2	34.2	36.8	36.9	22.8	45.4	50.6	43.6	24.8	8.4	6.7
Total asset (trillion Rp)	7.9	15.3	20.9	26.7	36.5	49.6	66.1	97.5	145.5	195.0	242.3	272.3	296.3
Market share (%)	0.65	1.20	1.46	1.63	1.77	2.14	2.70	3.20	4.19	4.60	4.80	4.89	4.61

Source: Islamic Banking Statistics 2003-2015 (Bank of Indonesia).

4. Current Condition of Islamic Banks in Indonesia

Indonesian Islamic banks began operation in the 1990s. At that time, Islamic banks in other Muslim countries such as Malaysia was already at the stage of development of their Islamic bank products. Islamic banks in Indonesia are now index in the Dow Jones and the Financial Times. Haron (2005) reported that, currently regulations and supervisions have been emphasized, and AAOIFI standards have been issued. These happenings indicate the development of Islamic banks in Indonesia.

Table 2 shows the development of Islamic banks in Indonesia from 2003 to 2015. The data revealed that, the

assets and shares of Islamic banks in Indonesia was below targets, thus the development of Islamic banks in Indonesia is yet to reach the set targets. In 2009, the total assets of Islamic banks was Rp 66 trillion, which was below the target of Rp 87 trillion set by the Bank of Indonesia. In 2013, the Islamic bank assets was Rp 242.3 trillion which was also below the target of Rp 255 trillion set by the Bank of Indonesia. Based on total assets, the market share of Islamic banks in 2013 was 4.8% of the total share of the national bank. The market share of Islamic banks was also below the target set by Bank of Indonesia that is 5% of the total share of the national bank market. Bank of Indonesia set a target of 5.25% in banking market share in 2014 for Islamic banks, but the market share position of Islamic bank in 2014 remained below 5%. There were no significant developments in market share position of

Indonesia Islamic banks even in 2015, it remained at 5%. Total assets of Indonesia Islamic banks amounted to Rp. 272 trillion, much lower than the total assets set by the national bank (Rp 5,615 trillion) (Bank of Indonesia, 2014).

The low market share of Islamic banks in Indonesia has led to low ranking on the world Islamic market. Islamic banks in Indonesia was ranked as eighth out of the nine Muslim-majority countries evaluated in 2011-2012. The country ranked first was Saudi Arabia, followed by Malaysia. Pakistan was ranked last after Indonesia (Kuwait Finance House Research, 2013). The market shares of Islamic banks in Indonesia is 20% lower than Islamic bank market shares of Malaysia (Witjaksono, 2015). The market share of Islamic banks in Indonesia is even lower than the market share of Islamic banks in the UK (Mansour *et al.*, 2010). This clearly shows that there is a problem with the development of Islamic banks in Indonesia. Thus the New Horizon Global Perspective on Islamic Banking and Insurance (2012) referred to Islamic banks in Indonesia as "the sleeping giant stirring".

Undoubtedly Islamic banks in Indonesia has shown some progress, however, according to Sula (2011) the development of a bank, should be seen from the market share. The market share reflects the (portion) from the sale of industrial goods or services carried out by an industry. Shaffer (1993) reported that market share is important, because it reflects the performance associated with bank's competitive position in the banking industry.

5. Discussion

Middle class group which consisted of Muslim intellectuals and educated Islamic scholars played important roles in the establishment of Islamic bank in Indonesia. These Muslim intellectuals and educated Islamic scholars were members of Indonesian Muslim Council (MUI), Indonesian Association of Muslim Intellectuals (ICMI), Muhammadiyah and other Islamic society organizations (Mufti and Sula, 2007). There are historical parallels between Indonesia and Malaysia about the term middle class. In 1970-1990, a New Economic Policy (NEP) in Malaysia opened up opportunities for education and economic empowerment of young Malays (Muslims). This policy enabled young Malays to be educated abroad in various disciplines and returned to Malaysia to form their own community structure termed middle class (Kahn, 1996; Crouch, 1996). Members of this group had power and influence in the political and economic situation in Malaysia. There were also other groups with high educational background and resided in urban areas (upper class or bourgeoisie) and those with no educational background and resided in rural communities (lower class or proletariats). These classes of people also occurred in Indonesia. From 1970-1990 was the era and rise of Indonesian Muslim intellectuals. They actively put forward ideas, pioneered and championed movements to include Islamic elements in politics and the economy of Indonesia. One of the activities of Indonesian Muslim intellectuals in the field of Islamic economy was the efforts put into the establishment of Islamic

banks in Indonesia.

Ariff (1988) believed the establishment of Islamic bank in a secular country like Indonesia, is a form of informal arrangements associated with public demand. This condition was termed as *bottom-up* movement by Karim (2007) and Muqorobin (2010). The *ulama* and Muslim intellectuals who were members of the MUI, ICMI and other Islamic organizations felt it was time to establish an Islamic bank in Indonesia, a country with the largest number of Muslims in the world. The group saw the need to establish Islamic banks to meet the financial needs of Muslims based on Islamic law. This situation was different from that of Malaysia and other Islamic countries such as Iran, Sudan, Jordan, Kuwait, Saudi Arabia and other Middle Eastern countries where the establishment of Islamic banks came from above or the government (top-down). With the support of the government in other Muslim countries, the establishment of Islamic banks was easier than that of Indonesia (Ahmed, 1990; Shallah, 1990; Wilson, 1990; Aryan, 1990; Gierath 1990). Due to the delay in the establishment of Islamic banks in Indonesia, the development of the Islamic financial systems also delayed. Hitherto the market share of Islamic bank is only about 5% according to national banking system of Indonesia. Thus the necessary commitments, efforts and hard work in pursuit of developmental increment in Islamic banks in Indonesia have to be put in place.

From the description above it can be concluded that the idea to set up Islamic bank in Indonesia was perceived and fought for before independence. However, there were some issues that hindered its establishment. The issues were religion, that is the problem of halal-haram interest, the laws of Indonesia, politics, social and financial resources (capital) (Antonio, 1992).

The first issue was about halal-haram interest. Indonesian Muslims were too busy fighting among themselves with the issue of halal-haram conventional bank interest. The debate raised potential conflicts among socialists, secular nationalists and Islamic scholars or groups which then called for a compromised idea. According to Mujiburrahman (2006) a compromised idea was eventually formed which gave a "gray area" for the establishment of Islamic bank in Indonesia.

The second issue was about the laws of Indonesia. This relates to the absence of a law which was fundamental to the operation of Islamic banks in Indonesia. This is because the concept of Islamic bank was not in accordance with the existing banking laws. Indonesia law No. 14 of 1967 concerning banking stated that, any financing transactions or loans made by the bank must be accompanied by interest (Rahardjo, 2002).

The third issue was political in nature. Strong desire of one party or group of people is not enough if the government does not support that desire. Experience with the establishment of Islamic banks in other countries showed the need for the strong commitment of Muslim community to adopt a way of life based on Islam, including the economical way. Strong support is also needed from the government and the Indonesian government at that time saw Islam as potentially threat to its activities. Until now, even the use of "Islam"

banking terms is still not allowed. Therefore Indonesia is the only country to use the term Shariah banks instead of the term Islamic banks.

The fourth issue was social in nature. Ariff (1998) concluded that the Muslim population in Indonesia has strong political influence simply because of their population (quantity), but there is lack of determination to bring about change. Social influences include the establishment of trust, shared values, and habits of people who use conventional banking services (Muhammad, 2005). The first bank in Indonesia, de Javasche bank was established in 1972 and operated on the conventional principles. As a result, people are familiar with the benefits of conventional banks, including Muslims. They have accepted it as a fair economic system. Therefore, their interest in using the services of Islamic banks without interest was low (Sudarsono, 2005)

The last issue was financial or capital fund to set up Islamic banks. It is still questionable to find someone who is willing to put up capital for the establishment of a modern bank? The lack of government support and the existing banking laws in effect at that time led to obstruction of opportunity for foreign banks to open branches in Indonesia. This situation resulted in the limited inflow of money from abroad, causing economic problems (capital) that made it difficult to receive huge funds for the establishment of an Islamic bank in Indonesia, though lots of offers came from banks in the Middle East who wanted to invest in Islamic banks in Indonesia (Rahardjo, 1998).

6. Conclusion and Implication

This study gives an overview of the establishment of Islamic bank in Indonesia and the issues behind it establishment. Delays in the establishment of the Indonesian Islamic bank compared with countries in other Muslim majority countries shows that the development of Islamic bank in Indonesia was slow. The current situation of Indonesian Islamic bank market share by the end of 2015 was about 5% which is lower than the target set by the national bank of Indonesia. Various issues hampered the establishment of Islamic banks in Indonesia. The fact is that, these issues are still relevant today, and they are threats to further development of Islamic banks in Indonesia. The findings of this study are useful for Islamic bank stakeholders to take steps to resolve issues that can interfere with the future development of Islamic banks in Indonesia.

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