

A Country Report on Indonesia

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I: INTRODUCTION

The present decade has witnessed a crisis everywhere in the world. The decade began with the ERM breakdown in 1992, followed by the Mexican Peso crisis in 1994, which spread to Latin America and then the latest 1997 crisis in South East Asia, which engulfed countries like Thailand, Indonesia, Malaysia, South Korea and the Philippines. The economies involved in the Asian crisis had been called the “Asian Tigers” for their outstanding performance since the late 1980s and early 1990s. If everything was going fine, then what went wrong in these economies to cause the crisis of this magnitude? What are the lessons that the world should learn from this Asian crisis? As Paul Krugman puts it, “The biggest lesson to learn from Asia’s troubles isn’t about economics; it’s about governments.”

Right from the start, the Asian Miracle encountered skeptics, who attributed the success of these economies to the “Perspiration Theory” rather than “Inspiration”. In their view, Asian economies flourished because they were hard working and not because they were smart. These economies succeeded namely because of their high savings rates, good education and migration of disguised-unemployed farmers to modern sectors. They were successful in promoting the right industries.

These Asian economies were consistently praised for their openness. The liberalization drive led to large inflows of loans denominated in foreign currency. The economies prospered. However, hidden behind the stupendous growth of the economy was the weakness of governments, who granted bailouts to banks, which encouraged massive lending, without an assessment of the profitability of the projects. The catch was that most investment was directed in unproductive projects, like real estate, construction, stock purchase and consumer loans. Soon most banks and finance companies were bankrupt. Because of these financial problems, foreign investors lost confidence in the economy and currency, which led to capital outflow. The first country that came under the attack was Thailand. The defense of the peg was difficult with the financial system weak and vulnerable, and interest rates could not be raised to prevent capital outflow. Devaluation was induced by speculators who sold Baht short. The peg was defended until June 1997, after which on July 2nd, 1997, the Baht was made to float (managed). There was a 40% devaluation of Baht against the U.S. Dollar. Thereafter, Thailand sought help from the IMF and other countries.

Indonesia and the Philippines widened their exchange rate bands, but Indonesia moved to a free float in mid-August 1997. Soon after this move, there was a massive devaluation of Rupiah and Indonesia sought IMF help in October. This contagion effect spread later to Singapore, Korea, Taiwan and Hong Kong.

Contrary to the “first generation” models of currency crisis (induced by fiscal deficits) and “second generation” models (induced by trade-off between short-run macroeconomic flexibility and longer-term credibility); this crisis has been mainly a result of financial excess and financial collapse.

Some of the basic problems with these Asian economies could be summarized as follows :

1. They all suffered from real appreciation of currencies. Since they all had fixed exchange rates, their currencies were overvalued.
2. Investment boom led to current account imbalances and huge foreign debt. To make matters worse, investment was in the wrong sectors (non-traded goods, real estate, speculative asset purchases).
3. The government bail-outs created “moral hazard” problems, whereby banks borrowed too much and financed even the marginal projects, which turned out to be unprofitable later.
4. Since borrowing and lending was going in **investing in speculative assets**, there was a bubble, which burst in 1997 and a simultaneous currency fall aggravated the debt problem as the burden increased in real terms.
5. There was a “competitive devaluation” game, as devaluation in one country decreased the competitiveness of other currencies.
6. The governments were weak, incredible and not committed to structural reforms.

Other factors affecting the competitiveness of Asian countries:

1. Chinese currency devalued in nominal terms by 50%.
2. Since most currencies were pegged to the U.S. Dollar, an appreciation of dollar led to appreciation of these currencies.
3. In 1995-96, there was a drop in demand for semi-conductors, the major export of these Asian countries.
4. Economic stagnation in Japan in 1990s was another factor responsible for decrease in exports (30% of exports went to Japan).
5. Industrial stagnation because of the above factors.
6. All these countries gained from the appreciation of Japanese yen in 1993-95, while lost their competitive edge when Japanese yen depreciated against the US dollar in 1996.

The rest of the report is structured as follows: Section 2 briefly describes the historical and political background of Indonesia. Section 3 has some trivia about Indonesia. Section 4 discusses the pre- and post-crisis Indonesia, with the emphasis on reforms being undertaken since 1985. Section 5 lists the events that led to the crisis, and specifically discusses Indonesia as a victim of contagion from the other countries. Section 6 discusses the role of the IMF in this South-East Asian Crisis. The last section lists the chronology of reforms in different sectors.

II: INDONESIA: History and Background

Prior to Dutch rule in the 15th and 16th centuries, Indonesia had never been unified under a single ruler. Before the 16th century, it had close commercial and cultural ties with India, from where it imported the Hindu and Buddhist beliefs (and Islam in the 13th century).

The Portuguese and the Spaniards reached Indonesia in early 16th century in search of spices. However, the first to colonize were the Dutch, who established the Dutch East India Company

(Vereenigde Oostindische Compagnie, VOC) in 1602. It exerted its rule indirectly, through local rulers; it was interested only in trade and not in territorial expansion. It was only in 1799, when the Dutch state took over the interests of VOC, and started its territorial conquest, which went on into the 20th century. In the early years of the 20th century, an “ethical policy” recognized that the Dutch owed their colonial subjects a “debt of honor”, and nationalism grew within the modern educated urban intellectuals. Following the defeat of the Japanese (after the Japanese conquest of the Dutch East India in 1942), these nationalists proclaimed the Independence of Indonesia on August 17th, 1945, under the leadership of Sukarno and Hatta. The struggle with the Dutch (who wanted to re-establish their rule) went on until December 27th, 1949, when the Dutch transferred the sovereignty over the archipelago, excluding the New Guinea, to Indonesia.

The territorial boundaries have been extended three times since then. On May 1st, 1963, sovereignty was granted over Dutch New Guinea, which was officially incorporated into Indonesia in September 1969. Indonesia invaded and annexed the Portuguese colony of East Timor, which was integrated into the country in 1976. Lastly, in April 1982, international recognition was accorded to Indonesia’s claim on islands far into the seas.

On the political front, there was instability for the first 15 years after Independence. In 1950, a liberal democratic republic was established, but frequent reshuffles in cabinets, regional revolts and economic mismanagement led to massive chaos. After 1959, President Sukarno replaced the elected House of Representatives with Provisional People’s Consultative Assembly. This period, known as “guided democracy”, saw political and economic upheavals. It ended in an abortive coup d’etat in September 1965, led by group of Army officers (supported by Partai Komunis Indonesia, PKI and Chinese arms and money). This coup ended the Sukarno Era (Old Order) and in March 1966 the New Order was established when executive power of the government was handed over to Major General Suharto. He became the acting president in March 1967, and has been elected for 6 further 5-year terms in 1973, 1978, 1983, 1988, 1993 and 1998.

III: INDONESIA: TRIVIA (Source: EIU)

BASIC DATA

<i>Land Area</i>	: 1,919,443 sq. km
<i>Sea Area (exclusive zone)</i>	: 3,166,163 sq. km
<i>Total Area</i>	: 5,085,606 sq. km
<i>Population</i>	: 199.9 million
<i>Main Towns</i>	: Population in ‘000, 1990 census
	Jakarta 8,228

Surabaya 2,484
Bandung 2,058
Medan 1,730
Semarang 1,251
Palembang 1,144

- Climate*** : Tropical
- Weather in Jakarta*** : Hottest months April-May, 24-31deg. C; coldest months
January-
February, 23-29deg. C; Wettest months January-February,
300mm average rainfall
- Languages*** : Indonesian (Bahasa Indonesia), as well as 250 other regional
languages and dialects. English has increasingly replaced
Dutch as the main second language, and is widely spoken in
government and business circles.
- Measures*** : Metric System
- Currency*** : Rupiah (Rp).
- Time*** : Western Zone 7 hours ahead of GMT, Central Zone 8 hours
ahead, Eastern Zone 9 hours ahead.
- Fiscal Year*** : April 1- March 31

POLITICAL STRUCTURE

- Official name*** : Republic of Indonesia
- Form of government*** : Strong Presidential Government based on the state ideology of
Pancasila.
- The Executive*** : Presidency is the highest executive office, with direct
legislative powers and authority to appoint cabinet; the
president is elected for a five-year term by the People's
Consultative Assembly (Majelis Permusyawaratan Rakyat,
MPR).
- Head of the State*** : The president, Suharto
- National Legislature*** : The 1,000-member MPR is nominally the highest authority in
the state and consists of members of the House of People's
Representative (Dewan Perwakilan Rakyat, DPR) and 500

appointed members; the MPR meets every 5 years to establish the guidelines of state policy and elect the president and vice-president; the 500-member DPR must approve all laws; 425 members are elected, while 75 representing the armed forces are appointed by the president.

National Elections : May 29th, 1997 (DPR), March 10th, 1998 (Presidential); next elections due May 2002 (DPR), March 2003 (Presidential)

National Government : Suharto is serving his 7th consecutive presidential term; Golkar controls 325/500 seats in the DPR.

Main Political Organizations: Majority Party- Sekretariat Bersama Golongan Karya (Golkar); Minority party- Persatuan Pembangunan (PPP; coalition of previously Muslim parties); Partai Demokrasi Indonesia (PDI; coalition of previously non-Muslim parties)

Central Bank Governor :

IV: INDONESIA: Pre- and Post-Crisis

Indonesian economic reforms began in 1986, with an emphasis on reducing the dependence of the economy on the oil-sector, increasing the role of the private sector, and creating employment by encouraging the establishment of a competitive non-oil, export-oriented industrial base. The reforms from 1986-1996 included:

- i. gradual liberalization of direct investment
- ii. maintenance of competitive exchange rate
- iii. trade liberalization and tariff reforms
- iv. better monetary management
- v. financial sector reform by liberalizing external inflows, making banking sector competitive, and promoting growth of capital market

The Indonesian economy was highly protected from the rest of the world around 1985. Resident individuals and juridical entities were allowed to invest abroad, while the bank and financial institutions were constrained from lending abroad. There were controls on inflows as well; direct investment inflows were limited by domestic ownership requirements; foreign investors could not purchase equity in the local stock market; there were limits on foreign borrowings.

Since then, the reforms have aimed at opening the real economy by promoting the direct investment flows and liberalizing the tariff system. Liberalization in the direct investment inflows involved expanding the fields where they were permitted, limiting equity ownership

rules in certain sectors, and increasing the length of time after which a company had to revert to domestic ownership.

On the exchange rate front, Rupiah was depreciated twice in 1983 and 1986 for the reforms to work. The payments and transfers for current international transactions was liberalized. The foreign exchange market was developed and selling of swaps was liberalized. Hence, the economy was geared towards openness and faster economic growth.

These initial reforms were accompanied by reforms in the financial sector. Interest rates were liberalized and direct credit controls on banks were removed in 1983. In 1987, reforms concentrated on strengthening the capital markets; introduced new capital market instruments. The monetary authorities targeted the international reserves; they were allowed to auction money market instruments daily and *interest rates and exchange rate were market determined*.

Improving the functioning of the banking system and developing the money market was the main emphasis of 1988 reforms. Foreign participation was encouraged in financial sector through the licensing of new foreign banks and branches. Functioning of the capital market was improved by increasing the role of the market in raising funds for investments, increasing the maturity of money market instruments, and broadening the range of market makers.

The portfolio capital inflows were liberalized in 1989 by removing the quantitative limits on borrowing from non-residents by banks. Foreigners could invest in the stock market, up to 49% of ownership of listed stocks. Foreign direct investors were also allowed to sell foreign exchange directly to commercial banks (rather than through central bank).

As a response to these reforms, the economy overheated in 1990-91; current account deficits widened, inflation rose, so did the rate of interest. Yet, higher interest rates attracted foreign capital, mainly in the form of commercial bank borrowing which was converted into domestic currency using the swap facility; this led to an increase in growth of money supply. Fiscal policy was tightened to curtail domestic demand pressures. Nonetheless, inflation followed an up-trend.

Since these inflows were interfering with the macroeconomic management, the 1991 quantitative restrictions were re-imposed on off-shore borrowing by banks and state enterprises. Limits were imposed on banks' open foreign exchange positions, and their swap positions as a percentage of their capital base was reduced. Yet, foreign borrowing for trade finance by private entities was encouraged.

A stable exchange rate, along with a large interest rate differential, invited large capital inflows (both direct and portfolio) in 1992-96. However, they were partially offset by the decrease in official capital inflows and the widening current account deficit. Also, the inflows were sterilized through the auctions of central bank paper and through swap operations in foreign exchange market.

Pressures on the Indonesian economy had been mounting since 1995-96. To encourage investment for the infrastructure development, on July 11th 1996, the government announced a 10-year tax holiday to investors in these sectors. These would apply to investment projects that would be completed within 5-7 years of obtaining a license. This was done to make the economy competitive vis-a-vis the neighboring countries, which were giving these incentives.

To give the companies an easy access to US capital markets, Bank Indonesia floated Yankee bonds on the NYSE on July 25th, 1996. The bonds earned a BBB rating from S&P and BAA3 from Moody's. It was oversubscribed by 200%, raising the total value of these instruments from \$300m to \$400m. This was done to diversify the government's financial resources and to provide a benchmark for debt instruments issued by Indonesian companies in the US.

On July 8th, 1996, a presidential decree was issued to implement a coherent strategy for privatizing the state-owned enterprises. Telecommunication company PT Indosat was floated in the 1st quarter of 1995, while PT Telecom and mining company PT Tambang Timah followed in the 1st quarter of 1996. Now, they turned to privatizing Bank Negara Indonesia 1946 (BNI), which was the largest state-owned commercial bank. But this made the banking sector's bad debts public. To prevent any kind of panic, the governor of Bank Indonesia, Sudradjat Djwandono, made public the fact that he was considering a mandatory write-off scheme for bad debts, conditional on banks having adequate reserves to cover such debts. Bad debts amounted to 2.35% of total bank credit, and of this almost 70% was held by the state banks.

On September 11th, 1996, Bank Indonesia raised the minimum reserve requirement from 3% to 5%, which reflected a concern for over-heating, although investment and inflation were low. Then, Rupiah's trading band against the dollar was widened from 5% to 8%, to maintain the competitiveness of exports by accelerating depreciation of Rupiah. These two policies were working at tandem, as the monetary authorities were trying to depreciate the Rupiah to encourage exports, on one hand, while tightening the monetary policy to raise the interest rates, on the other hand, so that Rupiah would appreciate.

There was a furore about the "National Car" policy, under which Suharto's youngest son got special incentives to produce cars. This was heightened when the EU, Japan and the USA lodged a complaint with the World Trade Organization (WTO) because allowing the import of cars from South Korea completely built-up, tax and duty-free was against the WTO rules, which require that imports can not be treated differently from locally produced manufactures.

This period was one when there was growing uncertainty on the political front. The DPR elections were to be held in June 1997, and Presidential elections in March 1998. Golkar's victory in the DPR elections would strengthen Suharto's chances of being re-elected for 7th term as the president. But, then Megawati Sukarnoputri was ousted from her chairmanship of the Democratic Party (PDI). This was done to sabotage her career in politics and so that Suharto could be elected unopposed in the March 1998 elections. However, this triggered

protests among the public and the media. The newspapers were asked by the government not to report any incidents of protests relating to Megawati and to refer to her by her married name, Megawati Taufik Kiemas, rather than her maiden name which had the name of her father in it, and which evoked memories of her father (whom people still respect). The right to hold rallies (Free-Speech Forum) and hold demonstrations was conceded by the military commander on June 21st 1996, when there was a violent clash between the military and the demonstrators. This heightened on July 27th 1996, when police in plain clothes wearing PDI T-shirts bombed the PDI headquarters and Megawati's supporters were rioted down by uniformed police, resulting in 90 injured people. This political unrest led to a fall in the stock market and Rupiah, as foreign investors began losing confidence in the government.

The beginning of 1997 saw a little bit of political stability as Suharto's re-election was seen as a forgone conclusion, but then uncertainty rose from who his running mate for the vice-president would be. Habibie was seen as Suharto's successor. This political stability brought with it the up trend in the stock market. The investor profile changed; earlier FII and ethnic Chinese business community dominated the stock market; now middle-class Indonesians increasingly sought to diversify their asset holdings by buying shares; their shares went up to 54% by October 1996 from 21% in April 1995. To popularize the stock market, the Indonesian Capital Market Society established a site on the World Wide Web (<http://www.IndoExchange.com>), making information transparent, accessible and open.

The trade balance improved over 1996 as the increase in prices of commodities and oil (\$20/b) boosted export revenues. On the other hand, there was a slight increase in spending on imports, as a result of tight economic policies and the weak Yen against the US dollar, which reduced the dollar value of Indonesia's yen-denominated imports from Japan.

Since inflation had been kept at amazingly low levels, Bank Indonesia lowered interest rates on March 12th, 1997, by 50 points on its money-market certificates. This was to refrain Rupiah from appreciating and increasing the competitiveness of exports.

However, Indonesians were growing dissatisfied with Suharto's nepotic rule, where the members of his family and friends had been given the power and the privileges. This became serious when in March 1997, the Hong-Kong based Political and Economic Risk Consultancy declared Indonesia at the bottom of the list in the survey conducted among expatriate business executives operating in various Asian countries. This was because politically influential people could arrange matters to their own financial benefit. Now, the privatization of banks was seen with suspicion as well (which were under-priced and half of the shares went to people linked to the first family). On April 1st, 1997, the inspection of all commercial cargoes entering Indonesia was handed back to the country's customs service (which was handed to a Swiss firm in 1985 through 1991 and then to a locally established firm). This was seen as a step that would breed nothing but inefficiency, red-tapism and corruption.

On May 29th, 1997, Golkar had an unprecedented victory in the DPR elections. This ensured a smooth re-election of Suharto for his seventh term in 1998. On the economic front, there was

continued inflow of foreign investment in the first half of 1997. Consequently, the central bank took steps to prevent credit growth through sterilization from sales of central bank certificates, increase in reserve requirements, and reduction in subsidized credit to private enterprises. Indonesia withstood the initial contagion from Thailand mainly because of its strong fundamentals. On July 7th, 1997, banks were banned from making loans to property developers for land purchases and land developments. However, on July 11th, 1997, to prevent speculation, Indonesia widened the trading band for exchange rate against US\$ to 12% from 8%. There was suspicion about the stability of the banking system and Rupiah came under the speculative pressure and was forced to float on August 14th, 1997. The immediate measures taken to combat this included limiting nonresidents' transactions in the forward market to \$5m per customer, and every bank's net open position to \$5m. The 49% limit on IPOs was also removed.

V: EVENTS LEADING TO THE CRISIS

Indonesia faced an enormous growth in real GDP in 1995- 8.1%-- from 7.3% and 7.5% in 1993 and 1994 respectively. This was accompanied by the concomitant worries about overheating—inflation increasing to 9.4%, current account deficits increasing to 3.9% of the GDP from 1.7% in 1994, and a 41% drop in trade surplus from 1994. The government's response had been lukewarm. It followed a slight contractionary monetary policy. The central bank, Bank Indonesia (BI), raised the RRR from 2% to 3% in January 1996 and to a further 5% in April 1997; it also used moral suasion to decrease bank credit. The two motives of dampening the domestic demand and not increasing the rate of interest were at odds. To meet both the objectives, BI widened the trading band in 1995 from 2% to 3% (to 5% in June 1996 and 8% in September 1997) around daily mid-rate in the hope that the wider band would increase the risk of holding the Rupiah, and would offset the high interest rates. This effort was in vain, since capital inflows were not discouraged.

The other initiative on the part of the government was to improve the efficiency and competitiveness of the export sector. This was highly controversial, as Asri Petroleum Group (established under Suharto's son Bambang Trihatmojo) received heavy tariff support, and there were worries that this might increase the costs for downstream producers. Then, in February 1996, the National Car Deal led to a huge controversy. Under this program, only qualified "pioneer" firms would be exempt from sales tax and tariffs on imported components. The only firm that received these benefits was Suharto's youngest son's (Hutomo Tommy Mandala Putra) firm, which collaborated with a Korean firm to import cars initially and then start to manufacture them at home. This treatment was not extended to any other firm even if they demonstrated the expertise needed for another three years. Despite the AFTA trade liberalization date being moved to 2003, in December 1995, Suharto insisted on a list of exemptions on goods such as cloves, rice, wheat flour, sugar, etc which were the monopolies owned by Suharto's family or close friends.

These government initiatives demonstrated the lack of willingness of the government to seriously address the economic problems pressing the country. This helped Indonesia in nothing else but earning the title of the “most corrupt country in Asia” in March 1997, according to a private Hong Kong survey of expatriate businessmen.

Overheating subsided in 1996, when real GDP growth slowed down to 7.8% and inflation to 6.6%. But the current account deficit remained high at 3.3% of GDP and mostly financed by short-term inflows of portfolio capital. Even BI cut rates by 0.5% in December 1996 and again in March 1997, to moderate the capital inflows, lessen debt burden on Indonesian firms, and increase exports. Yet, Indonesian firms were heavily borrowing in international capital markets. The offshore borrowing was not reported correctly, hence there was an underestimation of foreign borrowing. When the economy was well into the crisis (December 24th, 1997), a report was made public that estimated the Indonesian debt at \$200 million, against the government’s estimate of \$117 million.

Unpredictability of the Crisis: This crisis showed no signs of predictability until all the countries were buried deep into it. The government deficits were low, capital inflows continued, credit ratings were high from all agencies, IMF reports did not show much signs of concern, and risk premia on bonds were low. There were no bells for alarm in Indonesia, at least. Traditional warning signals (growing current account deficits, overvalued exchange rates, declining exports) were ignored; although current account deficits were low in Indonesia.

The victims faced more of a financial crisis. Financial indicators were indicating risk. But, again they were ignored since the economies had been doing so well on the economic front (in terms of GDP growth). Short-term debts to international banks rose to high levels relative to foreign exchange reserves in Indonesia. These were indicators of concern, but not to a crisis of the magnitude in Asia. Also, these indicators showed vulnerability to crisis, but did not guarantee the onset of a crisis.

Some of the factors that added to the crisis were:

- bank closure in Thailand,
- corporate failure in Korea,
- political uncertainty in all the countries,
- contagion because of incredible governments, and
- last but not the least, the IMF intervention (which recommended a sudden closure of financial institutions which led to a much greater panic).

Contagion, Panic and Crisis in Indonesia: Despite Indonesia’s own internal problems, which included under-supervised banks, extensive crony capitalism, corruption, monopoly power and growing short-term debt, this country seems to be the clearest case of contagion, as this country had least severe imbalances as compared to Thailand (Radelet-Sachs). The following statistics would support the above statement:

- Current account deficit at 3.5% of GDP was the lowest of Asian-5 economies;

- Export growth in 1996 at 10.4% (though down from 13% in 1995) was the second highest in the region;
- Budget had been in surplus by an average of over 1% of GDP for 4 years;
- Credit growth was at more modest level compared with other countries in the region;
- Foreign liabilities of commercial banks at 5.6% of GDP was way below the other affected economies (although the corporate foreign debts were high);
- No major corporate bankruptcies, and the stock market continued to rise through early 1997 until the onset of crisis in Thailand.

Indonesia was praised for widening the Rupiah band to 12%, and then floating it without wasting foreign exchange in defending the peg. Under the severe attack in August 1997, the government raised the interest rates high, which intensified the short-run pressures. The government lost its credibility when it first cancelled 150 investment projects to gain international confidence, and then a few days later reversed its decision.

Radelet-Sach felt that Indonesia had enough foreign reserves (\$20 billion) that it did not need the IMF program. But when Indonesia signed its IMF program on October 31st, 1997, the Rupiah did strengthen as a result of concerted interventions by Japan and Singapore. But this was very short-lived. Abrupt bank closures and concomitant bank runs, high interest rates, and decapitalization of banks led to a 23% depreciation of Rupiah and a 19% fall in stock market between November 3rd and December 4th, 1997. This was heightened by the closure of bank belonging to Suharto's son who publicly balked and threatened to take legal action. Soon after aid from the IMF arrived, Indonesia looked as weak as its neighbors.

The drought in December led to high food prices and food shortages. It was becoming increasingly difficult to manage the situation as the import of food became expensive with the exchange rate crisis, and displaced urban day laborers could not return to rural areas to find work. Simultaneously, the fall in petroleum prices decreased Indonesia's export earnings, which further added to the pressure on exchange rate.

Uncertainty in the region grew when Korea signing its IMF program on December 4th, 1997. The illness of Suharto, without a successor in sight, added to the panic. In January 1998, Indonesia was renegeing on its structural reforms and was contemplating the adoption of a currency board, which perpetuated the negative perceptions about the country. At this point, the crisis was both political and economic.

In short, the crisis in Indonesia was not caused by poor economic fundamentals. The crisis was caused by foreign lending lent to private firms, instead of banks. The lenders assumed that these firms had government guarantees, which was not true. Signs of crisis did not appear until July 1997, when the stock market was rising, international credit ratings were high and international bank lending continued. Hence, in Radelet-Sachs' opinion Indonesia unnecessarily faced an economic contraction, and is a clear case of contagion leading to panic.

VI: ROLE OF THE IMF

On November 4-5th, 1996, Bank Indonesia sponsored an ASEAN Conference (with IMF) in Jakarta to explore the Macroeconomic Issues Facing ASEAN Countries. The conference participants (including the top economists from the IMF and also the IMF Managing Director, Michel Camdessus) believed that macroeconomic performance of the ASEAN countries would remain strong for the following reasons:

- Pervasive aversion to high inflation made policymakers conscious about maintaining macroeconomic stability
- All nations were focussed on maintaining low inflation and reducing current account deficits, to make the economies external shock-proof.
- Monetary policy was geared toward financial liberalization, increasing savings in both public and private sector, and strengthening the banking systems throughout the region.
- The market-oriented policies ensured the efficient use of the region's high rate of investment
- These economies were persevering with structural reforms, in particular liberalizing trade and increasing openness
- Emphasis on high rate of growth of the economies to catch up with the developed world

The extent to which the *IMF was part-ignorant* about the brewing crisis is evident in the statement by Camdessus at the BI-IMF Conference: "He paid a tribute to the region's prudent fiscal policies, high domestic saving rates, and emphasis on infrastructure investment. These have produced a stable macroeconomic environment and sustained high quality growth, which also fosters human development, promotes equity, safeguard the environment, and allows enhancement of cultural values of ASEAN countries. ASEAN's role in the world economy, and in the IMF, is clearly growing." (IMF Survey). *But he warned that this could bring in challenges*. These nations should be concerned about sustainability of current account and soundness of domestic financial systems, as the huge capital inflows could bring in concomitant problems of higher expenditures, increased inflationary pressures, huge current account deficits, and expansion of domestic credit. He suggested that the ASEAN countries should

- Decrease reliance on foreign saving;
- Ensure that the private capital inflows take the form of long-term investment;
- Strengthen domestic banking system;
- Ensure an appropriate role for the state.

However, none of the countries paid any heed to what Camdessus was foretelling, until after they were knee deep into the crisis, like Indonesia. On October 31st, 1997, the IMF approved a 36-month stand-by loan of \$40 billion. Out of this package, \$10 billion was contributed by the IMF, \$8 billion by the World Bank and the Asian Development Bank, \$5 billion and \$3 billion by Japan and U.S., respectively, as a second line of defense, \$5 billion from Indonesia's own reserves, and the rest by other governments. According to the *IMF Survey* April 6th, 1998, Indonesia went into a Stand-by arrangement on November 5th, 1997. It is

expected to expire on November 4th, 2000. The amount approved was 7338.24 million SDRs²; out of this 5136.77 million SDRs are still un-drawn.

Camdessus applauded Indonesia's "Impressive Economic Policy Program." The program was supposed to be implemented in three legs:

- Strong monetary and fiscal policies for adjustment and restoration of confidence in the economy;
- Restructuring the financial sector and enhancing its soundness in future;
- Significant deregulation and trade reforms to improve economic efficiency

The IMF approved the Standby credit of SDR 7.3 billion (\$10.1 billion) to Indonesia on November 5th, 1997, over next three-years to stabilize and structurally reform the economy. Of the total, SDR 2.2 billion (\$3 billion) was immediately released and a further tranche of SDR 2.2 billion was to be available after the review of reforms in December 1997. The Standby credit is equivalent to the 490% of Indonesia's quota of SDR 1.5 billion (\$2.1 billion) in the IMF.

The nine goals of the IMF programs were (Radelet-Sachs):

- Prevent outright default on foreign obligations;
- Limit the extent of currency depreciation;
- Preserve a fiscal balance;
- Limit the rise in inflation
- Rebuild foreign exchange reserves;
- Restructure and reform the banking sector;
- Remove the monopolies and otherwise reform the domestic non-financial economy;
- Preserve confidence and creditworthiness;
- Limit the decline of output.

To achieve these goals, the policy components were:

- Contraction on Fiscal Policy
- Close sick and bankrupt banks. (16 commercial banks were closed in Indonesia)
- To improve the confidence in banking system, the IMF pushed the banks to meet the capital adequacy standards
- Tightening domestic credit through contractionary monetary policy to defend the fall in exchange rate.
- Full payment of foreign debt obligations, bailed out of IMF funds
- Structural changes like reducing tariffs, opening up sectors for foreign investment and reducing monopolies.

In all, three countries approached the IMF for help. Thailand got a 34-month Standby arrangement of \$17.2 billion on August 20th, 1997; Indonesia a 36-month one of \$40 billion

² Special Drawing Rights (SDRs) consist of a valuation basket of 5 currencies (the US dollar weighted 39%, Deutsche Mark 21%, Japanese Yen 18%, French Franc 11% and U.K. Pound 11%).

on October 31st, 1997 and Korea a 3-year Standby of \$57 billion on December 4th, 1997. Despite these sizable loans, the IMF programs were ineffective in curing these economies; mostly because they were not implemented in their original form. Hence, **new letters of intent** were signed with Thailand, Indonesia and Korea on November 25th, 1997, December 24th, 1997 and January 15th, 1998 respectively. Currencies and stock markets continued to fall; bank closures led to financial panic; credit ratings fell.

In February 1998, Indonesia announced Comprehensive Reforms. Camdessus believed that Indonesia was taking measures to eliminate structural distortions and restrictions:

- All special privileges to the National Car Program had been eliminated;
- Special funding to IPTN, aircraft manufacturer, had been rescinded;
- Restrictive marketing arrangements had been abolished;
- Domestic trade in agricultural products had been liberalized;
- BULOG monopoly was restricted only to rice.
- To maintain confidence in the economy, the government guaranteed the obligations of depositors and creditors.

The IMF blamed the contagion effects, political uncertainty and ineffective implementation of the programs by the governments to be the cause of the deteriorating situation (Stanley Fisher in IMF Survey January 26th, 1998). This was true to some extent. Korea's situation aggravated the situation in Indonesia and Thailand; Suharto's health and elections in Korea added to the uncertainty; and governments were not following the programs whole-heartedly. Indonesia is a classic example of this. The IMF proposed to do away with the monopolies. When Suharto was re-elected in March 1998, he made Mohammad Hasan as the Industry and Trade Minister, and he heads the plywood monopoly that the IMF ordered dis-banned as a condition for the \$43 billion bailout. This was evidence of renegeing on the IMF conditionalities.

However, the IMF was partially liable for the continuing deterioration. Some of the inherent problems with the IMF programs were:

- Abrupt closure of banks in Thailand and Indonesia increased the panic, squeezed the liquidity and made bank operations more difficult. Foreign creditors became more apprehensive and refused to rollover the loans. The IMF apparently recognized it's mistake in January; but by then the depositors and foreign lenders had already withdrawn their funds and banks had cut down on loans.
- Pushing banks to re-capitalize in a short span of time led to a severe credit crunch, distress for private firms and an increase in non-performing loans. Indonesian banks were asked to raise the capital adequacy ratio to 9% by end of 1997, and to 12% by 2001 (above the previous level of 8%).
- Insistence on using monetary policies to raise interest rates even higher (they were left high by the flight of foreign capital) was harsh economically. The profitability of the banks was decreased and this enhanced the economic downturn. The IMF apparently assumed that higher rates of interest would help stabilize the currency and even lead to appreciation; and the benefits of currency stabilization would outweigh the short-run output costs. Since the currencies never appreciated, the IMF assumption is questionable.

- Unnecessary emphasis on the fiscal surplus (the magic figure was 1% of the GDP), especially when budget profligacy was not the source of the crisis, and why contract the economies when there were other contractionary sources already at play. The IMF again recognized it's mistake and proposed a 1% budget deficit in it's second program for Indonesia.

VII: CHRONOLOGY OF REFORMS

CAPITAL MARKET REFORMS

1983: Interest rates were liberalized and are market determined

1984: Introduction of Money market instruments (SBI)

1985: Introduction of standardized form of banker's acceptances (SBPUs)

1987: Simplification of listing requirement in Jakarta Stock Exchange (KSE)

- Introduction of Bearer securities
- More flexibility given to interest rates
- Bank Indonesia was given more room to regulate liquidity through daily auctions in SBIs and SBPUs.
- Introduction of Over the Counter market
- Elimination of SBPU discount ceilings
- Forceful transfer of deposits from state-owned banks to bank Indonesia by state owned enterprises.

1988: Reforms emphasized the functioning of the banking system, enhanced bank supervision, development of money market and improving the functioning of the capital market (extended the role of the market in raising funds for improvements, lengthening the maturity of money market instruments, and broadening the range of market makers)

1991: Increase in the minimum number of shares traded in a single block on the "big board" of JSE from 10,000 to 20,000, but all traders are allowed to deal in odd-lot transactions of less than 500 shares.

- Tightening of licensing requirements for traders, brokers, underwriters and investment advisors, and of disclosure requirements, with any irregularity to be reported to Capital Market Executive Agency, BAPEPAM, within three days

1992: Commercial banks allowed to issue securities through the stock exchange

- Privatization of JSE ended, with the management being transferred to PT BEJ

1993: Introduction of measures to ensure fair distribution of shares from oversubscribed issues.

- Unofficial trading in shares before their listing was declared illegal
- Ceiling on pricing of issues was imposed (Maximum: Price/Earning = 13)

1994: Ceiling on pricing of issues raised to 15.

1995: Introduction of computerized trading on JSE

- Subrabaya Stock Exchange and Over the Counter market merged to encourage participation by small investors

1996: Introduction of regulations permitting an increase in foreign ownership of mutual funds and securities companies, restricting speculative derivatives transactions and tightening disclosure requirements.

- Introduction of 6-point plan to enhance the information dissemination, improve auction techniques, facilitate trading between institutional and retail markets, reduce trading credit risk through the establishment of a Clearing and Guarantee House, develop a safe and efficient Central Securities Depository and reduce costs through book-entry settlement.

1997: Regulation on margin trading to curb speculation; requiring only securities companies with net operating capital of at least Rp5bn (\$2m) would be allowed to provide margin facilities with effect from August 1st, 1997

- Foreign companies were allowed to list their shares on Indonesian markets
- Abolishment of 49% cap on foreign ownership of Indonesian initial public offering (IPO)

BANKING REFORMS

February 1991: Improved standards and supervision; timetables were established in order to build up capital base to meet capital adequacy ratio (CAR) of 8% as recommended by Bank for International Settlement (BIS)

March 1992: New law simplifying banking system

May 1993: Modified standards to increase short-term lending; established phased deadlines for banks to abide by prescribed legal lending limits

June 1995: Introduced a new tax regulation to encourage inter-bank mergers

August 1995: Deposit protection scheme announced by Bank Indonesia to compensate depositors whose banks become solvent or are shut down by the monetary authority.

September 1995: Minimum paid-up capital requirement for banks seeking foreign-exchange license is raised from Rp50bn (\$22.2m) to Rp150bn to encourage mergers and strengthen capital bases of commercial banks.

September 1996: Minimum reserve requirement for commercial banks is raised from 3% to 5%

July 1997: temporary ban on property loans by commercial banks since half of the non-performing loans were related to property loan accounts.

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**International Claims Held by Foreign Banks ; Distributed by Maturity and Sector
(billions of dollars)**

	<u>End-1995</u>	<u>End-1996</u>	<u>Mid-1997</u>
Total Outstanding	44.5	55.5	58.7
Obligation by Sector:			
Banks	8.9	11.7	12.4
Public Sector	6.7	6.9	6.5
Non-bank Private	28.8	36.8	39.7
Short-Term	27.6	34.2	34.7
Reserves	14.7	19.3	20.3
Short-term/ Reserves	1.9	1.8	1.7

International Claims Held by Foreign Banks; Distributed by Country of Origin (billion of \$)

	<u>End-1995</u>	<u>End-1996</u>	<u>Mid-1997</u>
Total Outstanding	44.5	55.5	58.7
Claims held by banks from:			
Japan	21.0	22.0	23.2
USA	2.8	5.3	4.6
Germany	3.9	5.5	5.6
All others	16.8	22.7	25.3

Market Creditworthiness; Long-Term Debt Ratings; 1996-97:³

	Jan.15 th 1996	Dec2 nd , 1996	June 24 th , 1997	Dec. 12 th , 1997
	Rating/Outlook	Rating/Outlook	Rating/Outlook	Rating/Outlook
Moody's Foreign				
Currency Debt	Baa3	Baa3	Baa3	Baa3
S&P's				
Foreign Currency Debt	BBB/Stable	BBB/Stable	BBB/Stable	BBB-/Negative
Dom. Currency Debt	-	A+	A+	A-/Negative

Euromoney Country Risk Rating (out of 180 countries):

<u>March 1993</u>	<u>March 1995</u>	<u>March 1997</u>	<u>Sept. 1997</u>	<u>Dec. 1997</u>
41	40	43	43	49

Overall Central Government Balance (%age of GDP):

<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
0.4	0.4	-0.4	0.6	0.9	2.2	1.2

Real Exchange Rate Index (Trade Weighted, WPI): (increase → depreciation)

<u>12/88</u>	<u>12/89</u>	<u>12/90</u>	<u>12/91</u>	<u>12/92</u>	<u>12/93</u>	<u>12/94</u>	<u>12/95</u>	<u>12/96</u>	<u>3/97</u>	<u>9/97</u>	<u>12/97</u>
98	93	100	99	92	88	92	89	80	75	99	150

³ Ratings from Highest to lowest: Moody's: Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3
S&P's: AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-

Indonesia: Selected Macroeconomic, Financial Sector, and balance of Payments Indicators

Source: Johnston, Darbar, and Echeverria (1997): Table 10

IMF International Financial Statistics, Information Notice System, and IMF Direction of Trade Statistics, various issues

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
<u>Selected Economic Indicators</u>												
Real GDP Growth	2.5	5.9	4.9	5.8	7.5	7.2	7.0	6.5	6.5	7.4	8.5	7.2
Inflation per annum	4.7	5.8	9.3	8.0	6.4	7.8	9.4	7.5	9.7	8.5	9.4	8.0
M2/GDP	23.9	26.9	27.2	29.6	35.0	43.3	43.7	45.8	43.4	44.9	48.3	52.5
Currency/Deposits	24.1	24.2	21.0	17.6	15.7	12.1	10.4	10.7	.....	.....	.....	.....
Fiscal Balance/GDP	-1.0	-3.5	-0.8	-3.1	-2.0	0.4	0.4	-0.4	0.6	0.9	2.3	1.2
Private Sector Credit/GDP	14.1	16.4	18.7	22.3	23.8	50.6	50.7	49.5	48.9	51.9	53.7	55.8
(Export+Import)/GDP	33.0	31.9	39.9	38.5	40.8	44.8	47.2	47.8	41.2	40.7	42.8	41.1
Current Account/GDP	-2.2	-4.9	-2.8	-1.7	-1.2	-2.8	-3.7	-2.2	-1.3	-1.6	-3.5	....
Financial Account/GDP	2.0	5.2	4.6	2.6	3.1	4.2	4.9	4.8	3.7	2.2	5.2	.....
<u>Interest and Exchange Rates</u>												
Nominal Deposit Rate (% per annum)	18.0	15.4	16.8	17.7	18.6	17.3	23.3	19.6	14.6	12.5	16.7	17.3
Real Deposit Rate (% per annum)	13.3	9.6	7.5	9.7	12.2	9.7	13.9	12.1	4.9	4.0	7.3	9.3
Interest rate Differential	8.9	8.4	9.2	9.3	9.3	9.1	17.0	15.4	10.9	6.9	10.5	11.5
Lending/Deposit Spread	....	6.1	4.9	4.4	3.1	3.3	2.2	4.4	6.1	5.2	2.1	2.0
Official Exchange Rate per US \$ (end of period)	1125	1641	1650	1731	1797	1901	1992	2062	2110	2200	2308	2383
Real Effective Exchange Rate Index (1990=100)	185.2	142.6	104.3	101.8	103.3	100.0	98.7	96.2	100.9	99.8	96.3	101.0
<u>Balance of Payments</u>												
Current Account, n.i.e.	-1923	-3911	-2098	-1397	-1108	-2988	-4260	-2780	-2106	-2792	-7023	....
Financial Account, n.i.e.	1782	4177	3481	2217	2918	4495	5697	6129	5632	3839	10386	....
Direct Investment Abroad	....	....	....	....	....	....	....	.....	-356	-609	-603	.....
Direct Investment in Rep. Eco, n.i.e.	310	258	385	576	682	1093	1482	1777	2004	2109	4348	....
Net Direct Investment	310	258	385	576	682	1093	1482	1777	1648	1500	3745	....
Portfolio Investment Assets	.....	.....	.....	.....	.....	.....	....	.....	.....	....	....	.....
Portfolio Investment Liabilities	-35	268	-88	-98	-173	-93	-12	-88	-1805	3877	4100	.....
Net Portfolio Investment	-35	268	-88	-98	-173	-93	-12	-88	-1805	3877	4100	....
Other Investment Assets	.....	....	....	.....	.....	.....	.....	.....	....	....	.....	....
Other Investment Liabilities	1507	3651	3184	1739	2409	3495	4227	4440	2179	-1538	2541	.....
Net Other Investments	1507	3651	3184	1739	2409	3495	4227	4440	2179	-1538	2541	.....
of which, Official Capital	1345	2886	2537	1756	2604	218	1287	770	552	137	131	.....
Net Errors and Omissions	651	-1269	-753	-933	-1315	744	91	-1279	-2932	-263	-1790	.....
Overall Balance	510	-1003	630	-113	495	2251	1528	2070	594	784	1573	.....
Net Private Capital	739	-901	-1810	-12090	-2165	4663	3302	6789	4943	5131	10097	....

ECONOMIC INDICATORS IN INDONESIA
(Source: Corsetti, Pesenti and Roubini, 1998)

	1990	1991	1992	1993	1994	1995	1996
Current Account as a %age of GDP (NIA)	-4.4	-4.4	-2.46	-0.82	-1.54	-4.25	-3.41
Current Account as a %age of GDP (BOP)	-2.82	-3.65	-2.17	-1.33	-1.58	-3.47	-
Trade Balance as a %age of GDP (BOP)	1.68	0.91	1.81	1.48	0.72	-1.03	-
GDP Growth	-	6.95	6.46	6.5	7.54	8.22	7.98
Investment rate as a %age of GDP	36.15	35.5	35.87	29.48	31.06	31.93	32.07
Stock Market Price Index	417	247	274	588	469	513	637 ⁴
Stock Market Price Index (Prop Sector)	-	119	66	214	140	112	143 ⁵
Savings rate as a %age of GDP	31.75	31.1	33.41	28.66	29.52	27.68	28.66
Government fiscal Balances (%of GDP)	0.43	0.45	-0.44	0.64	0.96	2.29	1.19
Inflation rate	-	9.4	7.59	9.6	8.53	9.43	8.03
OpennessX+M/2GDP	26.3	27.18	28.23	25.26	25.94	26.98	26.24
Exchange Rate (US\$)	1842.8	1950.3	2029.9	2087.1	2160.8	2248.6	2342.3
Real Exchange Rate	97.4	99.6	100.8	103.8	101.0	100.5	105.1
Foreign Reserves (month of import)	3.24	3.53	3.62	3.6	3.24	2.94	3.61
M1/Foreign Reserves	1.73	1.48	1.3	1.44	1.58	1.53	1.21
M2/Foreign Reserves	6.16	5.51	5.61	6.09	6.55	7.09	6.5
Bank Lending to pvt Sector(%growth)	-	17.82	12.29	25.48	22.97	22.57	21.45
Lending to pvt sector (%GDP)	49.67	50.32	49.45	48.9	51.88	53.48	55.42
Foreign Debt(%GDP)	-	68.21	68.74	56.42	54.58	53.35	-
ST debt(%total)	-	14.5	15.52	16.97	18.36	18.75	-
Debt Service/Export	-	34.3	32.6	33.6	30.7	30.9	-
ST debt/Foreign Res.	-	124.59	130.69	134.29	146.06	147.47	-
Debt service+ST debt as a % of Foreign Res	-	248.54	249.91	259.43	263.69	267.25	-

⁴ 401 in 1997

⁵ 40 in 1997