Indonesia: crisis, reform and recovery

In Indonesia, state-owned banking gave way to a system where anyone with $1 million or so could open a bank (Little 1997, 10).

In mid-1998, a World Bank study (1998) grimly noted that “Indonesia is in deep economic crisis. A country that achieved decades of rapid growth, stability, and poverty reduction is now near economic collapse . . . no country in recent history, let alone one the size of Indonesia, has ever suffered such a dramatic reversal of fortune.” There is bitter irony in Indonesia’s fall from grace. Long hailed as a model of successful economic development, it was widely expected to escape the fate of Thailand. Between June and August 1997, as Thailand’s economy unraveled and the virulent Asian flu sent shock waves through the region, the Indonesian economy remained relatively stable – seemingly a veritable rock in the stormy sea. Even the World Bank (1997) remained upbeat about the short-term outlook, believing that a modest widening of the intervention band (from 8 per cent to 12 per cent) within which the rupiah was allowed to be traded would be sufficient to ward off contagion. The Indonesian government, which received much praise for its swift and decisive response to the crisis, went to great lengths to assure jittery investors “that Indonesia was not Thailand.” Then the unthinkable happened. Indonesia suddenly succumbed to the contagion, and measured by the magnitude of currency depreciation and contraction of economic activity, it emerged as the most serious casualty of Asia’s financial crisis. In fact, with an economic contraction of 15 per cent in output in 1998, Indonesia experienced the most severe economic collapse recorded for any country in a single year since the Great Depression of the 1930s.

What happened? Why did Indonesia (and the other high-performing Asian economies) collapse like hollow dominoes? In the numerous post-mortems that have followed, analysts have identified a number of related factors behind the region’s dramatic reversal of fortune. In the case of Indonesia,
the variable that soon acquired particular salience was “crony capitalism.” Initially popularized by The Economist (1998), the term quickly took on a life of its own. Soon thereafter, Paul Krugman would argue that crony capitalism lay at the root of Indonesia’s, indeed, East Asia’s, financial woes. Krugman’s emphasis on crony capitalism, while not without merit, is too simplistic. After all korupsi, kolusi dan nepotisme (corruption, collusion and nepotism), has long been pervasive in Indonesia. It was hardly an obstacle when Indonesia notched up impressive economic growth-rates for some three decades prior to the crisis. Back then, crony capitalism was politely referred to as the “government–private sector nexus” and viewed as a unique feature of the East Asian “developmental states” and even a necessary prerequisite for development. Rather, this chapter argues that a more nuanced understanding of Indonesia’s economic crisis can be gained by differentiating between the sources of “vulnerability” and the “precipitating” factors. A careful review of the events leading to the crisis shows that both these factors converged during the critical period between late August 1997 and March 1998 – and practically everything that could go wrong did over these months. The greatest source of vulnerability, indeed, the fundamental weakness lay in Indonesia’s over-guaranteed but under-capitalized and under-regulated banking sector. The precipitating factors were the contagion, but also, more importantly, poor macroeconomic management by the Suharto regime; and to a lesser extent the International Monetary Fund exacerbated the crisis.

The background

The fact that nobody saw Indonesia’s impending collapse is hardly surprising. Hal Hill (1999, 8) notes that before the crisis “almost every technical economic indicator looked safe.” Likewise, Furman and Stiglitz (1998) found that the Indonesian crisis was the least predictable out of a sample of 34 potentially troubled economies. Indeed, for a country that was dismissed during the Sukarno era (1949–65) as a “chronic dropout” and one that “must surely be accounted the number one failure among the major under-developed countries,” Indonesia’s economic development in the post-Sukarno era was nothing short of miraculous.2 In the first half of the 1960s, foreign-exchange reserves shrank to zero (in 1965), inflation skyrocketed to over 600 per cent annually, government deficit rose to some 3,000 per cent of revenues, and per capita income fell by 15 per cent between 1958 and 1965 (Bhattacharya and Pangestu 1997, 390–3; Prawiro 1998, 1–18). In sharp contrast economic growth averaged 7 per cent between 1970 and 1989 and 8 per cent between 1990 and 1996 (Booth 1999, 110–12). This growth occurred alongside substantial industrialization and structural change, as agriculture’s share of GDP declined from 55 per cent in 1965 to 19.4 per cent in 1990,
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while industrial output expanded from 13 per cent to 42 per cent – with a corresponding rise in the share of manufactures in GDP from 8 per cent to 20 per cent by 1990 (Jomo 1997, 133; Booth 1999, 113). By 1993, manufactured exports reached US$21 billion and accounted for 53 per cent of total exports (World Bank 1996, 216). It is important to note that, unlike what happened in many other developing countries, Indonesia’s proportional shift from agriculture to industry did not come at the expense of agriculture. On the contrary, the first five-year plan (or Repelita 1) introduced in 1969 emphasized agricultural and rural infrastructural development. Not surprisingly, agriculture accounted for almost 30 per cent of the rapid economic growth achieved from 1967 to 1973. While Indonesia was a major beneficiary of the oil and commodity boom of 1973–81, unlike many other oil exporters it used the earnings prudently – avoiding the familiar “Dutch disease” problem (or how to protect the competitiveness of the non-oil economy from the adverse consequences of oil windfalls) by wisely investing in manufacturing and agricultural production as well as in improving social services. As Booth (1999, 114) notes, after 1973, “revenues from oil company taxes were used to increase agricultural productivity.” New high-yielding and pest-resistant varieties of rice were developed and distributed. These efforts contributed to a burst of growth in rice production between 1979 and 1985, when total output of the crop increased by 49 per cent.

By the mid-1990s, manufacturing had been the leading engine of growth in Indonesia for more than a decade, contributing roughly one-third of the increase in GDP from 1983 to 1995. However, this rapid expansion of manufacturing was not simply the result of growth of industries based on processing petroleum and natural gas (in 1995 these two activities accounted for less than one-tenth of total manufacturing output); the other nine-tenths comprised a diverse range of manufacturing industries. Some of these, such as motor vehicles, were oriented largely toward the domestic market, while wood products, garments, textiles, footwear and electronics were mainly sold abroad. As a result, by the late 1980s the economy had become more trade-dependent, with total trade flows as a percentage of GDP rising sharply from 14 per cent in 1965 to 54.7 per cent in 1990. These developments increased the capacity of the economy to mobilize savings, as reflected in the rise of national savings as a percentage of GDP from 7.9 per cent in 1965 to 26.3 per cent in 1990 (Jomo 1997, 133).

Equally impressively, the quality of life for the average Indonesian improved greatly, as per capita income rose from US$75 in 1966 to US$1,200 in 1996. These gains were spread fairly equitably. For example, between 1976 and 1990 income per person in the poorest quintile of Indonesia’s population grew by 5.8 per cent per year, whereas the average income of the entire population grew by 4.9 per cent per year. To put this success in some comparative context: in 1967 per capita income in Indonesia was less than one-half that of India, Nigeria or Bangladesh. By mid-1997, it was five times
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that of Bangladesh, four times that of Nigeria and three and a half times that of India (Kenward 1999a, 73). With such growth, the proportion of population living below the official poverty line declined from 64 per cent to an estimated 11 per cent between 1970 and 1996 – one of the largest reductions in poverty recorded anywhere in the world during the period. Other socioeconomic indicators bear out this success. For example, consumption of foodstuffs such as rice, meat and dairy products rose continually since the late 1960s. Between 1968 and 1995, daily protein intake per Indonesian improved by more than 60 per cent – from 43.3 to 70.0 grams (Booth 1999, 129). Infant mortality declined from 145 per 1,000 live births in 1970 to 53 per 1,000 in 1995, life expectancy rose from 46 to 63 years during the same period, and the country achieved universal primary education in 1995. While Java, in particular greater Jakarta, was the main beneficiary, the benefits of economic growth extended to all Indonesia’s twenty-seven culturally diverse and far-flung provinces (World Bank 1998, 75). Mills (1995, 7) sums up Indonesia’s achievements in these words:

Indonesia’s growth rate over the past 25 years has transformed a desperately poor society in which malnutrition, illiteracy and infant mortality were widespread into one with a large middle class, one in which nearly all children are educated and in which infant mortality and malnutrition have decreased dramatically. The benefits of such relatively rapid growth are not shared equally in any society, but all major groups benefitted greatly: farmers, factory workers, industrialists, small business owners, government employees and the urban poor.

One of the repeated boasts of Suharto New Order Government (1965–98) was its defeat of the rampant hyperinflation of the Sukarno era, and its ability to keep budget deficits low and in balance. Indeed, prudent macroeconomic management kept the budget broadly balanced for an unprecedented 30 years – or the entire length of the Suharto era. Immediately on assuming office, the Suharto regime eliminated the fiscal deficit through drastic expenditure cuts and passed a “balanced budget” law in 1967 prohibiting domestic financing of the budget in the form of either debt or money creation. Again, effective macroeconomic management helped Indonesia steer through the difficulties of the steep oil price increases and declines in the 1970s and 1980s, and kept the macro-economy largely in balance right up to the onset of the crisis in mid-1997. As was noted earlier, the government essentially proscribed domestic financing for the budget throughout – a strategy that kept both expenditures and monetary growth under relative control. Moreover, the government also adopted a stringent monetary program to bring down inflationary pressures. By 1969, inflation had been reduced to less than 20 per cent and external accounts were brought into balance (Bhattacharya and Pangestu 1997, 394). Since the mid-1980s, inflation has been kept within single digits, and on the eve of the crisis was about...
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6 per cent (McLeod 1999, 209). Finally, the exchange-rate was adjusted to realistic levels through large devaluations, while the administered system of foreign-exchange allocation was gradually replaced by a market mechanism. Following the unification of the exchange rate in 1970 and a further devaluation in 1997, the capital account was fully liberalized. In 1967, Indonesia rejoined the World Bank and the IMF, which enabled it to receive substantial foreign assistance for its adjustment program and work out arrangements to reschedule its foreign debt.

In contrast with those of Thailand and Malaysia, Indonesia’s current account deficit in the 1990s averaged only 2.6 per cent of GDP. In fact, not once in any year between 1990 and 1996 did its annual current-account deficits ever exceed the average over the period 1983–89. The 1996 current account deficit of 3.5 per cent was comparable to those of previous years, and less than half the level in Thailand. Thus, the deficit on the current account of the balance of payments looked healthy and manageable. Also, unlike the case in Thailand, there was no serious exchange-rate misalignment, as Indonesia’s exchange-rate policy was gradually relaxed (via widening of the intervention band) by Bank Indonesia, the country’s central bank. Two large devaluations of the rupiah in 1983 and 1986, and the ensuing policy of allowing it to float (within a band) downward relative to the US dollar led the exchange rate to decline steeply over time in real terms. Because of this policy, which lasted until the rate was freed in August 1997, Indonesian exports could be competitively priced in dollar terms on world markets. This policy enabled Indonesia to compete successfully with producers of labor-intensive manufactures in the region, including China.5 Finally, Bank Indonesia had substantially increased its stocks of international reserves. Indeed, international reserves, both in absolute terms and in months of merchandise imports, were comfortable and rising just prior to the crisis. The external debt to GDP ratio was gradually declining, and was appreciably lower than during the difficult adjustment period of the mid-1980s. And, with the exception of 1990, Indonesia had an excess of private savings over investment in the period 1990–96. The budget surplus averaged over 1 per cent in the four years prior to the crisis, and credit growth was modest. In short, the traditional economic indicators looked sound.

Sources of vulnerability

With such an enviable record of development and seemingly sound economic fundamentals, what went wrong? The roots of the crisis can be traced back to the mid-1980s, when Indonesia embarked on an ambitious economic reform program. The reforms were designed to diversify the economy in order to reduce its dependence on the oil sector, encourage the development of a competitive non-oil export-oriented industrial base that would absorb

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the rapidly growing labor force, and expand the role of the private sector, including foreign capital. Key elements of the reform measures between 1985 and 1996 included: (a) gradual liberalization of direct investment inflows to promote non-oil exports and economic diversification; (b) maintenance of a competitive exchange rate; (c) trade liberalization and tariff reform; (d) improvements in monetary management; (e) financial sector reform through liberalization of external inflows; and (f) the promotion of competition in the banking sector. For example, in October 1988 deregulation removed most of the entry barriers. New banks, whether joint ventures or domestic, could now be set up with capital requirements of Rp. 50 billion and Rp. 10 billion respectively. Regulations on opening new branches were substantially relaxed and reserve requirements were drastically reduced (Bhattacharya and Pangestu 1997, 417). In addition to all this there was an objective of encouraging the growth of the capital market by extending the role of the market in raising funds for investments and lengthening the maturity of money-market instruments. Further, in 1989 the authorities liberalized portfolio capital inflows by eliminating quantitative limits on banks borrowing from non-residents. Foreigners were allowed to own up to 49 per cent of the shares issued by listed domestic companies (except banks), while domestic companies were allowed to raise funds by selling securities in local and international stock and bond markets. In 1990, restrictions on direct investment inflows were further relaxed, and foreign direct investors were allowed to sell foreign exchange directly to commercial banks instead of through the central bank, and to purchase securities on the stock market and on the over-the-counter bourse. However, as the following sections will illustrate, such rapid liberalization without putting the necessary prudential regulations in place, combined with haphazard implementation of the reform measures, made Indonesia highly vulnerable to economic shocks.

Indonesia’s seemingly endless growth potential and its adoption of market-friendly economic policies attracted foreign investors. Moreover, “commercial banks bustled to get more overseas funds. Their activities resulted in an increase in liabilities from Rp. 11 trillion in March 1989, to Rp. 17.5 trillion in March 1990, and to Rp. 31.6 trillion in March 1991” (Rosul 1998, 246). In fact, capital inflows increased almost two and one-half times from 1990–94, reaching US$14.7 billion (Nasution 1999, 76). Overall, between 1990 and 1996, Indonesia experienced a surge in capital inflows averaging about 4 per cent of GDP. Although not as large as the inflows received by Thailand (10 per cent of GDP) and Malaysia (9 per cent of GDP), cumulatively it still represented a large volume of capital for the economy to absorb effectively. Indeed, by mid-1997, Indonesia’s total debt outstanding to foreign commercial banks amounted to US$59 billion. What made Indonesia particularly vulnerable was the maturity structure of the foreign borrowing. According to the Indonesian government’s own figures, by the end of June 1997, out of the US$140 billion (about 60 per cent of GDP) in external debt,
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approximately US$33 billion was short-term debt with maturities due within one year (IMF 1997a). In addition to this amount, Indonesian firms also took out large lines of short-term credit in foreign currencies both directly from foreign lenders and from Indonesian banks – greatly adding to their foreign currency exposure. By contrast, foreign exchange reserves in mid-1997 stood at about US$20 billion. In other words, short-term debts owed to foreign commercial banks were about 1.75 times the size of Indonesia’s total foreign exchange reserves (Radelet 1999, 3).

The massive inflow of short-term capital was no accident. Indonesia’s exchange-rate system made short-term debt particularly attractive. From the mid-1980s until August 14, 1997, the Indonesian government maintained an intervention band system (the so-called “crawling peg regime”) under which the government pledged to intervene in the markets through means such as foreign-exchange purchases and interest-rate adjustments if the rupiah depreciated or appreciated against the US dollar beyond a set percentage. The authorities typically targeted the nominal depreciation of the rupiah against the dollar at between 3 per cent and 5 per cent per annum. There was little variation in this, as Bank Indonesia intervened in the foreign-exchange market by buying and selling the rupiah in an intervention band around the central rate. The reasoning behind such an activist policy was to stabilize the real exchange rate, thereby discouraging speculative capital inflows and giving monetary authorities greater flexibility to control monetary aggregates. However, the predictability of the exchange rate made short-term dollar loans seem less risky, and therefore much more attractive. For example, an Indonesian bank borrowing in US dollars could simply compare the cost of purchasing a hedging instrument with the maximum depreciation of the rupiah against the US dollar permitted under the intervention band during the term of the loan. Thus, hedging the currency exposure would only be economically justified when the cost of the hedging instrument was less than the maximum potential depreciation of the rupiah under the intervention band system. Because short-term funding on an unhedged basis was so attractive, and because of the fact that borrowers were led to believe that the expected losses from currency depreciation would be less than the cost of hedging foreign borrowings, the greater part of the banking sector’s foreign borrowing remained unhedged. As Radelet (1999, 3-4) notes, “this predictability [of the exchange rate] also undercut the incentives for firms to hedge against their exposure to exchange rate movements. According to one estimate, hedging [against the risk of exchange rate movements] would have added about 6 percentage points to the cost of borrowing. Very few firms covered their exposure.” Thus, Indonesian banks were faced with an unhedged funding mismatch between borrowing short-term offshore in foreign currency and lending long-term in rupiah. This mispricing of foreign credits, combined with the increased supply of funds in the global financial markets, contributed to
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very large capital inflows and created vulnerability for firms with substantial foreign-exchange exposure.

In addition, domestic firms and corporations found short-term foreign-currency loans appealing, since they carried relatively lower interest rates. In fact, firms assumed that they would be able to roll over their loans easily when they fell due – after all, this is what they had done for several years before the crisis. Foreign lenders also complied, often not undertaking adequate appraisal of their investments. Radelet (1999) aptly notes that Indonesia’s vulnerability was all the greater because its largest creditors were Japanese banks, which provided about 40 per cent of the total credit from foreign banks. The underlying weaknesses of Japanese banks made them more likely to try to pull their loans quickly once the crisis began. Indeed, this is precisely what happened. In mid-August 1997, as Thailand reached agreement with the IMF on its first program, Japanese banks agreed to keep US$19 billion in trade and other credit facilities open for certain Thai commercial bank borrowers. Not wanting to be caught again in similar situations in other countries in the region, the Japanese banks began to withdraw their credits from Indonesia, Malaysia, Korea and other countries – helping to spread the crisis further.

Indonesia’s crawling peg regime unintentionally contributed to another problem: a modestly overvalued exchange rate and slowing export growth. This trend sharply increased after the 1987 Plaza Accord, which brought down the value of the US dollar and ushered in a new era of the appreciating yen. Between 1985 and 1988 the yen almost doubled in value vis-à-vis the dollar and other Asian currencies tied to the dollar. More broadly, by 1988 the yen was almost 30 per cent above its average for the 1980–85 period on an inflation-adjusted, trade-weighted basis (Ito and Iwaisako 1996). By the mid-1990s, the era of the strong yen was over, as was indicated by the sharp appreciation of the dollar in 1995, and especially its appreciation vis-à-vis the yen. As the dollar rose relative to the yen, the currencies of the countries tied to the dollar (like Indonesia) rose in comparison with the yen also. Radelet (1999, 4) notes that between 1990 and mid-1997 the rupiah appreciated approximately 22 per cent in real terms, while growth in Indonesian non-oil exports slowed from an annual average of 26 per cent in 1991–93 to 14 per cent between 1993 and 1995 to just 10 per cent in 1996–97. This modest overvaluation and export slowdown, although smaller than in the other crisis-affected countries, clearly pointed toward the need for some moderate adjustments to re-establish the international competitiveness of Indonesian firms. Moreover, although the Indonesian monetary authority maintained a more flexible foreign-exchange policy by adjusting its currency according to its current-account deficit levels, this was not enough to correct the productivity gap between Indonesia and its competitors in the region. Indonesia’s real effective exchange rates appreciated despite the nominal depreciation, and its export markets, dependent upon imported raw materials
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and cheap labor, were eroded by the competition from China and Vietnam in the early 1990s.

Vulnerability also came from the way the capital inflows were utilized. The massive capital inflows soon created problems of absorption. While capital was invested in productive investments such as infrastructure development, electricity generation and heavy industries such as petrochemicals and automobile assembly, a significant portion also found its way into the non-tradeable sector and, in particular, real estate. As Dominique Fischer (2000, 225) notes, “from an almost non-existent stock in 1987, modern office space grew to 2.8 million square meters, shopping centers reached 1.2 million square meters and the stock of luxury condominiums was estimated at 15,000 units.” Such aggressive development only fueled speculative overbuilding, particularly in Jabotabek, or the greater Jakarta area. Why real estate? The surge in private capital inflows relative to the size of the equity market quickly drove equity prices up. Investments in real estate, especially, housing, hotels and tourist resorts, amusement parks, golf courses and shopping malls, looked promising. Foreign lenders able to easily purchase stock, commercial paper and real estate were only too eager to finance these projects – not only because they seemed to be good investments, but also because, with many of these projects controlled either directly or indirectly by Suharto’s family and their cronies, they assumed that the projects carried an implicit guarantee from the Indonesian government (Sender 1994; 1997).

Perhaps Indonesia’s greatest vulnerability lay in its weak financial system, especially its dangerously undercapitalized and poorly supervised banks. What explains this weakness, and why was it allowed to persist? A brief background is necessary. First, while the central bank, Bank Indonesia, was responsible for supervising the country’s banking system, it nevertheless reported directly to the president during the Suharto era. This left the entire banking system open to both indirect and direct political interference. It is widely agreed that on numerous occasions prudential rules were violated by the well-connected without fear of any punishment from the central bank. In fact, during the latter part of the Suharto era, banks not only lent amounts well in excess of legal lending limits, but politically-driven lending to well-connected borrowers and projects took place without regard to the underlying economic viability of the borrowers or the projects. Thus, although Indonesia had, on paper, a modern and fairly comprehensive set of banking regulations, the rules were hardly enforced. Such irregularities only raised the moral hazard stakes.

Second, while reform of the Indonesian banking system was initiated in 1983 with the abolition of Bank Indonesia’s control over interest rates on deposits and loans, it was in October 1988 that Bank Indonesia enacted a package of major banking reforms known as the “October 1988 Package” or PAKTO 88 – which according to former Bank Indonesia Governor,
J. Soedradjad Djiwandono (1998, 7–8), “fundamentally changed the face of banking in Indonesia.” Since the government saw banks as the key financial intermediaries in mobilizing funds, the main aim of PAKTO 88 was to encourage competition in the banking sector by lowering the barrier to entry, including the liberalization of the requirements for the establishment of new private domestic banks and joint-venture banks. To this effect, PAKTO 88 ended segmentation of the financial market and improved market competition. Also, PAKTO relaxed the restrictions on the establishment of private and foreign-owned banks, as well as the restrictions on existing banks opening new branches – this included the granting of permission to state-owned firms to deposit 50 per cent of their short-term funds with private banks, instead of only with state-owned banks. In addition, for the first time, foreign banks were permitted to set up branches outside Jakarta in any of the nation’s six major cities, provided that 50 per cent of their loan portfolio went to export-oriented businesses. Foreign partners could also hold up to 85 per cent of the value of the new banks, which had to have minimum paid-up capital of US$30 million (Djiwandono 1998, 8; Prawiro 1998, 242).

Moreover, PAKTO permitted extremely low capitalization, setting the minimum paid-in capital requirement for newly established banks at the rupiah equivalent of US$5 million. It also allowed more foreign ownership of domestic assets and abolished the limits on inflow of foreign direct investment and foreign ownership of equities issued in domestic stock markets. Further, bank reserve requirements were sharply cut from 15 per cent to 2 per cent of third-party funds (defined as all demand, savings, and time deposits, plus certificates of deposit from unrelated parties). Deregulation in 1989 eliminated the need for Bank Indonesia’s approval for medium- and long-term loans and removed ceilings on offshore loans (Montgomery 1997, 11–12; Djiwandono 1998, 8–10). In addition, the government moved to deregulate equity, bond, insurance and related financial activities. Not surprisingly, two months after PAKTO 88 there were 111 commercial banks and 1,957 bank offices. By the end of 1992, the numbers had jumped to 208 and 5,495 respectively. By the end of 1996, commercial banks dominated the financial system in Indonesia. Most of the new entrants were small or joint-venture banks, which fragmented the sector and intensified the competition for funds. In 1996, out of a total of 238 commercial banks, there were 7 state-owned banks, 27 regional government banks, 160 private banks, 34 joint-venture banks, and 10 foreign banks. In addition, there were approximately 9,200 rural banks called bank perkreditan rakyat (BPR), and one Islamic bank (Bank Muamalat). Non-bank financial institutions included 252 finance companies, 163 insurance companies, about 300 pension and provident funds, and 39 mutual fund companies. Total assets of the system were equivalent to about 90 per cent of GDP. Commercial banks held 84 per cent of total assets, while rural banks held about 2 per cent.
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The remaining assets were held by finance companies (7 per cent of total assets), insurance companies (5 per cent), and other non-bank financial institutions (2 per cent). As Pincus and Ramli (1998, 725) note, “by the early 1990s, Indonesia possessed one of the most liberal banking systems in the world.”

While these reforms succeeded in transforming a closed banking sector dominated by a small number of state-owned banks into a more diverse and competitive system, and brought benefits to the economy, such as more efficient credit allocation and financial intermediation (not to mention, providing Indonesians with many more options for financial services), banking deregulation also posed challenges that the authorities failed to meet. First, in 1983–88, the seven state banks’ share of total outstanding bank credit hovered around 65 per cent, but after three years of liberalization their share had dropped to 56 per cent in 1991 and to 40 per cent by the end of 1997 (Chou 1999, 37). State banks have historically played an important role in the allocation of subsidized credit (at preferential interest rates), known as “liquidity credit,” to priority sectors assigned by Bank Indonesia. This credit-allocation system, often subject to political abuse, greatly curtailed the state banks’ ability to compete with private banks. Liquidity credits and access to Bank Indonesia re-discounting facilities were extended to sugar estates and refineries, rubber and palm-oil plantations, and construction contractors among others. As will be discussed, such practices dragged the entire state sector into the red by 1994. Second, the problem of moral hazard occasioned by explicit or implicit government guarantees induced reckless lending, especially to the well-connected. Indeed, there was a strong presumption in the financial and business community that neither investors nor lenders would ever bear the full cost of any corporate or bank failure. This belief was fostered by the close links between powerful business groups, who also often controlled financial institutions, and the government. Investors and bankers were led to assume that the government would eventually bail them out if they got into trouble, even in the absence of explicit government guarantees. As Krugman (1998) observes, when government actions suggest that there is an explicit guarantee against either bank or corporate failure, such implicit guarantees can trigger asset price inflation and make the financial system vulnerable to collapse. And, third, the failure to develop simultaneously the necessary prudential supervisory, regulatory and legal framework (and enforce what regulation did exist) made Indonesia highly susceptible to a system-wide banking crisis.

For example, the financial reforms resulted in a rapid expansion of bank credit – a variable widely regarded in financial markets as an indicator of financial vulnerability, since high credit: GDP ratios weaken the capacity of central banks to push up interest rates in defense of the currency during a crisis. Outstanding bank credit increased by an average of 24.3 per cent per
year from 1992 to 1996. Part of the credit expansion was financed by foreign borrowing, and when restrictions on lending were lifted, banks began to expand credit to property and real estate, including ambitious and costly infrastructure projects. Bank Indonesia’s own figures show that bank lending to the property and real estate sector increased by roughly 40 per cent from 1995 to 1996 (Djiwandono 1999; 1999a). While the competitive, if not speculative, market environment (not to mention the easy availability of bank credit), increased the pressure on banks to lend without careful risk-assessment, Nasution (1999, 80), notes that “Indonesia’s prudential rules and regulations were poorly implemented and largely unenforced . . . bank credit officers who were reared in the pre-reform environment may have lacked the expertise to evaluate new sources of credit and market risk.” Furthermore, the comparatively poorly compensated officials at the state-owned banks, who viewed their job security and career advancement as being essentially dependent on their ability to satisfy powerful individuals and the well-connected, hardly bothered to assess the creditworthiness of the borrowers. Not surprisingly, in the case of the state-owned banks, risky lending practices were often the result of both explicit and implicit pressure exerted by members of the Suharto family, their cronies and other high-ranking military and government officials to make loans to favored borrowers. Indeed, the practice of making loans based on political pressure became known as “memo lending,” because such loans were extended on the basis of a “memo” sent by the powerful and well-connected. Soon memo lending and other illegal practices led to high levels of non-performing loans at the state-owned banks.

The case of a government-owned development bank, Bank Pembangunan Indonesia (also known by its acronym as Bank Bapindo), is illustrative. In 1994, Bank Bapindo lent some US$436 million to the Golden Key group, at that time a little-known Indonesian konglomerat (conglomerate) owned by a colorful businessman, Eddy Tansil, with close links with senior military and government officials. The loan was never repaid, and a later government investigation alleged that the loan had been extended on the basis of fraudulent documentation and with the complicity of key Bapindo executives and government officials, including the former minister of finance, Johannes Sumarlin – who at the time was also a member of Bapindo’s board of commissioners (Habir 1999). Regulators and central bank supervisors were also involved in fraud and collusion. However, instead of closing down or restructuring the bank, the government allowed the bank to continue to operate. Also, only bank officers (but not the managers) were punished for corruption. Similarly, in the case of commercial paper issued by PT Bank Pacific, PT Bank Arta Prima and PT Bank Perniagaan, only four supervisors of Bank Indonesia were arrested in early August 1997 for allegedly taking bribes during inspections between 1993 and 1996. Nasution (1999, 83) supplies the macro dimension of the problem:
Despite average annual economic growth of over 6 per cent since 1990, the volume of problem loans held by Indonesia’s banks remained considerable. In 1995, 8.8 per cent of total bank credit outstanding was classified as sub-standard, doubtful, or bad debt. As of November 1996, the bad debt of the banking system amounted to Rp. [rupiah] 10.4 trillion (equivalent to about 2 per cent of GDP or around 10 per cent of total loans). Of this amount, state-owned banks held Rp. 7.1 trillion (68 per cent).

Thus the rapid growth of the private banks was achieved at the expense of sector soundness. That is, in the case of the private banks, risky lending practices usually involved banks making loans to affiliated companies – which also included affiliated property companies. Specifically, since liberalization increased the attraction of the financial sector to commercial and industrial concerns, many of Indonesia’s large business conglomerates opened one or more private banks. Most of these banks were not managed on an independent basis, but as funding sources for the affiliated businesses – extending loans to suit the funding needs of the businesses and on terms dictated by the affiliated businesses’ senior office-holders, rather than on the basis of diligent risk-assessment of the companies’ creditworthiness. While there were rules regarding the aggregate amount that a bank could lend to its affiliated companies, there were no clear provisions to enforce the rules. Not only were the staff and resources of the central bank insufficient to allow for adequate inspections of the banks under its supervision; indirect or intra-group lending could in any case easily be concealed. Thus, loans to affiliated companies were among the riskiest loans held by the private banks.

The case of Bank Summa is illustrative. This bank was one of the first private banks established after the enactment by Bank Indonesia of the 1988 banking reforms. Prior to its collapse, Bank Summa was one of the ten largest banks in Indonesia. It was owned by the influential Soeryadjaya family, who also had major controlling interest in Astra International, one of Indonesia’s largest conglomerates. In the second half of 1990, Bank Summa began to face serious financial problems, mostly as a result of the deteriorating quality of its large portfolio of loans. Many of the “bad” loans were in the real estate sector, and 70 per cent of these loans had been extended to related parties, exceeding the legal limit by far (Enoch et al. 2001, 23). For two years, Bank Indonesia relied on its traditional approach of holding talks with the shareholders and trying to persuade them to solve the bank’s problems while continuing to provide liquidity support – which by the end amounted to 25 per cent of the bank’s total liabilities (Enoch et al. 2001, 24). In June 1992, a memorandum of understanding formalized the owners’ commitment to repay the non-performing connected loans and recapitalize the bank. However, the owners failed to meet their commitment. Faced with a fast-growing liquidity need, Bank Indonesia decided in November 1993 not to grant any additional liquidity support, and revoked Bank Summa’s license. In December 1992, Bank Summa collapsed. At the time of Bank Indonesia: crisis, reform and recovery
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Summa’s liquidation, it was estimated that more than 70 per cent of its loan portfolio was non-performing and that a high percentage of these loans had been made to its affiliated companies. In total, Bank Summa had amassed more than US$750 million (0.6 per cent of GDP) in non-performing loans (Enoch et al. 2001, 23). Nasution (1999, 85–6) notes:

Indonesia’s weak market infrastructure, malefiance and malversation together have allowed the emergence of so-called “swindle” banks. The typical swindle bank makes loans to non-bank companies owned by its principal owner(s) to finance questionable investment projects, usually at inflated prices. Liabilities of such banks are mainly deposits owned by the general public, liquidity credit from Bank Indonesia, unsecured commercial paper sold to the general public (including foreigners), and equity shares owned by Bank Indonesia and other state-related institutions . . . Such banks typically have negative net worth.

By the early 1990s, Bank Indonesia was quite aware that the country’s banks, given their high level of exposure to property companies, faced a potentially disastrous problem. As is well known, investments in property and real estate are long-term and highly risky, because they are very sensitive to future growth expectations. In contrast, the liabilities of the banks were mostly short-term and denominated in US dollars, Japanese yen and other foreign currencies. Also, in many cases, banks had taken no collateral, and those that had taken collateral took a pledge over property as collateral for loans. In any case, they could hardly collect, because a fall in real estate prices would mean that by the time of default the property used to secure a loan would be worth only a small fraction of the outstanding principal amount loaned. Moreover, as was noted earlier, short-term borrowing from abroad was a relatively inexpensive source of funds provided that the banks did not incur additional costs purchasing hedging instruments to protect themselves from any depreciation of the rupiah against the currency they had borrowed. Unhedged foreign-currency borrowing posed an obvious risk to a bank, in that any depreciation of the rupiah during the term of the loan would mean that the amount in rupiahs needed to repay the loan on maturity would be far greater than the amount the borrower received upon drawing the loan. In short, Indonesian banks were faced with an unhedged funding mismatch between borrowing short-term from abroad in foreign currency and lending long-term in rupiah. All these asymmetries of the banks’ balance sheets added greatly to their overall riskness.

In an effort to address these problems, the Indonesian government enacted the Banking Law (known as Banking Act No. 7) in 1992. The Banking Law allowed sanctions to be imposed on bank owners, managers, and commissioners for violations of laws and regulations related to bank management. Also, the law contained provisions designed to restrict the aggregate amount that a bank could lend to affiliated companies to 20 per cent of the bank’s capital, and converted some state banks to limited liability companies and
permitted them to lend only to non-priority sectors. In October 1992, as part of the project to limit the number of banks, the capital required to set up a domestic bank was increased fivefold. In 1995, reserve requirements were raised from 2 per cent to 3 per cent effective February 1996. In addition, the minimum capital required for banks with foreign-exchange licenses was tripled, and the capital adequacy ratio for these banks was raised from 8 per cent to 12 per cent – with both these measures to be phased in over a five-year period ending in 2001. Bank Indonesia also developed a supervisory system patterned on the United States CAMEL system (Capital, Asset Quality, Management, Earnings, Liquidity), including annual on-site examinations of banks. Moreover, the system stipulated necessary qualifications of bank owners and managers, a schedule to meet the Bank for International Settlements (BIS) capital adequacy requirement (CAR) of 8 per cent on risk-weighted assets, stricter information and reporting requirements, and tougher limits on lending within a corporate group or to one individual. In fact, by the end of 1996 prudential practices in Indonesia’s banking sector were largely in line with those recommended by the Basle Committee, and comparable to those adopted in the United States and the European Union.

However, the Indonesian government’s efforts to improve and promote best practice came when the sector was already deeply troubled by high levels of non-performing loans. Moreover, the enforcement of these measures was generally quite lax, and violations rampant. Bank Indonesia’s own report acknowledged that as of March 1997 a significant number of banks remained undercapitalized and not in compliance with the prudential rules. While these figures very probably understate the extent of non-compliance, according to Bank Indonesia 15 banks did not meet the required 8 per cent capital adequacy ratio in April 1996, while 41 banks did not comply with the legal lending limit, and 12 licensed foreign-exchange banks did not meet the rules on net open foreign-exchange exposure (Montgomery 1997, 13). Also, many of the banks continued to maintain their high level of exposure to the property and real estate sector. During 1996, even as the glut in the property market became apparent and real estate prices began to nosedive, Indonesian banks continued to lend to property companies. In 1997, despite large-scale losses reported by the property industry, bank lending to the property sector totaled about 19.4 trillion rupiah, a 21 per cent increase from 1996 (Hammond 1997). In July 1997, Bank Indonesia issued a decree that was intended to restrict bank credit to real estate developers severely; but it was too little too late. Undercapitalized and, in large measure, burdened with poorly diversified and badly performing loan portfolios, Indonesia’s over-guaranteed but under-regulated banking system lay exposed and highly vulnerable to economic shocks.

Finally, lurking menacingly beneath were the political vulnerabilities. Specifically, as Indonesia’s patrimonial-authoritarian regime succumbed to
favoritism and cronyism, this began to take its toll on economic activity. Specifically, in the late 1980s and early 1990s, Suharto’s children and the regime’s close allies rapidly expanded their business activities. Soon Suharto’s children and cronies were involved in almost every economic activity in the country – first in natural resource-based ventures, then in manufacturing, and later in a range of services, from construction to the operation of toll roads, telecommunications and financial services. Richburg (1998, A40) lucidly describes the nature of “Suharto Incorporated.”

The Suharto children are all reputed to have become multi-millionaires by trading on their direct line to the presidential palace, which involved everything from clove cigarettes to toll roads, from petrochemical plants to automobile manufacturing. So pervasive is the first family’s reach into the Indonesian economy that a long-running joke here is that the corruption begins as soon as you arrive at Jakarta’s international airport: You can buy a pack of cigarettes, hop in a taxi, take a toll road to the city and check into a hotel, putting money into a Suharto family member’s pocket with each step.

Indeed, as Blustein (2001, 91) notes, “by the 1990s, the Suharto family’s avarice was so pervasive that almost any foreign firm investing in, say, a power plant or phone system or petrochemical factory had to hand over lucrative partnership rights to one presidential relative or another to grease the project’s way through the country’s bureaucracy.” Yet, as was noted earlier, while corruption and cronyism were hardly new in Indonesia, what differentiated the late 1980s and 1990s was Suharto’s unwillingness to make prudent economic decisions when his children’s and cronies’ business interests were at stake. Indonesia’s “national car” policy is illustrative. In February 1996, Suharto announced a national car policy designed to provide competition in the automotive industry, especially to the monopoly held by the Astra Group, led by an ethnic-Chinese Indonesian entrepreneur, William Soeryadjaya, and its Japanese partners, Toyota, Daihatsu and Isuzu. The program gave a three-year exemption from import duties and luxury taxes to those Indonesian companies that manufactured cars locally using an Indonesian brand-name and local parts. The conditions attached to these exemptions were demanding. They required companies to attain a local content of 20 per cent after the first year, 40 per cent after the second year, and 60 per cent after the third year. However, as Hale (2001, 631) notes, “it was what happened next, however, that really stunned the domestic business community and international observers.” On February 27, 1996, the national car policy promulgated in the Presidential Instruction No. 2/1996 gave a “pioneer” status to PT Timor Putra Nasional (TPN) – jointly owned by Suharto’s youngest son, Hutomo (“Tommy”) Mandala Putra and the KIA Motor Corporation of South Korea. This special status gave TPN a one-year exemption on tariffs and taxes, despite the fact that the company did not even make cars. Moreover, this exclusive status exempted the company
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from paying the 65 per cent maximum import duties for car spare parts, and the 35 per cent maximum import duty and luxury goods sale tax that make up over 60 per cent of the cost of car production in Indonesia. Also, as Hale (2001, 632) notes, “adding insult to injury, in June 1996 President Suharto issued the presidential decree that allowed the national car to be assembled in Korea for the first year of operation.” In effect, TPN was given permission to import CBU Kia sedans from South Korea and sell them under the Timor brand-name for one year. Furthermore, TPN could sell these cars at a duty-free price that significantly undercut those of its competitors; to boost the sale of the car, the public sector was required to purchase it.12 Finally, fully backed by the Indonesian government, Bank Indonesia, and a consortium of 4 state-owned banks and 12 private domestic banks, the company received an initial US$960 million for its production and assembly facility. Despite these advantages, “the inability of Tommy’s newborn firm to organize itself quickly or well enough to assemble Kia’s components in Indonesia had led Suharto to indulge his son: For one year, Tommy could bring up to 45,000 finished Timors into the country from South Korea for sale free of the stiff tariffs and luxury tax that other such imports would still have to face” (Borsuk 1999, 149). As King (2000, 617) notes, “this cronyism was so brazen ... as to anger even the regime's staunchest supporters.” Indeed, in July 1997, with Thailand already in the early stages of the crisis, “Indonesia’s biggest state and private banks were arm-twisted by the government to supply US$650 million to Tommy to build a Timor factory east of Jakarta” (Borsuk 1999, 149).

Likewise, against the advice of respected economists, Suharto continued to support the lucrative monopolies his children and cronies enjoyed over the soybean and cloves industries. Specifically, since the mid-1980s, PT Sarpindo Soybean Industri – owned jointly by two of Suharto’s children and his wealthiest and oldest friends, Liem Sioe Liong of the Salim Group and the plywood magnate, Mohamad (“Bob”) Hasan – had been the sole processor of soybeans into bean curd (a major source of protein for Indonesians), and the sole producer of soymeal, an important ingredient in animal feed. Moreover, while only the state food distribution agency (Badan Urusan Logistik or BULOG), was allowed to import soybeans to meet the growing demand, it had to use Sarpindo’s crushing facility for processing soybeans. As Borsuk (1999, 150) notes, “Bulog paid a fee substantially higher than the world price for crushing soybeans. Sarpindo got a further bonus in the form of the soybean oil that crushing yielded, which Sarpindo was allowed to keep and sell at a handsome profit.” Besides this, Liem controlled Indofood, the world’s largest instant-noodle maker and Bogasari Flour Mills, the world’s largest flour-milling operation, which held effective monopolies in the Indonesian market thanks to government contracts, special import licenses and subsidies. Cloves, on the other hand, are the key ingredient used in the manufacture of Indonesia’s distinctive spice-flavored cigarettes known as
In order to corner this lucrative market for his son Tommy, Suharto designated cloves an “essential commodity,” to be regulated by the state. This decision was followed in early 1991 by the creation of the Clove Support and Marketing Agency (Badan Penyangga dan Pemasaran Cengkeh or BPPC), with Tommy as chairman. As Borsuk (1999, 152) notes, “to keep the monopoly going, Suharto ordered the central bank to give more than $350 million in subsidized credit to the BPPC. Thus did Tommy’s scheme make losers of the farmers, the firms, the government, and the smoking and non-smoking public. The only winners were Tommy himself and the BPPC.”

All the growing vulnerabilities now needed was a trigger. The trigger was the contagion from Thailand. On July 2, 1997, when the Bank of Thailand abandoned the baht’s peg to its traditional basket, the baht immediately depreciated sharply against the US dollar. Pressure then quickly intensified against the Philippine peso and the Malaysian ringgit – each of which received only limited support from their central banks. On July 8, the rupiah came under pressure. Although Indonesia had stronger macroeconomic fundamentals than Thailand (as these pertained to exports and the fiscal balance), and only a modest current account deficit, the rupiah was, nevertheless, vulnerable for two principal reasons. First, the huge foreign-debt burden of the private Indonesian corporations (much of it short-term and not hedged against exchange-rate changes), and second, the fundamental weakness of the financial and banking sector raised doubts about the government’s ability to defend the currency peg.

The Indonesian government’s initial reaction to speculation against the rupiah was decisive. Unlike Thailand, rather than defending its currency and squandering a large portion of its reserves, Bank Indonesia, on July 11 widened the trading band for the rupiah from Rp. 192 (8 per cent of the central rate) to Rp. 304 (12 per cent of the central rate), in a pre-emptive move designed to deter speculation. It also limited non-resident transactions in the forward market and introduced an array of tight monetary policy along with administrative measures to limit the external borrowings of commercial banks. Indeed, Indonesia was widely praised for its strategy of “deft macroeconomic management” (Blustein 2001, 97). Yet it was too early to celebrate. Despite the vigorous defense the rupiah continued to slide. As the then Governor of Bank Indonesia, J. Soedradjad Djiwandono (1999a, 145) noted, “the market reaction to the central bank (Bank Indonesia) move was contrary to experience.” Every time the Bank Indonesia intervention band had been widened previously (five times from 1994 to 1997), an appreciation of the rupiah followed. This time, the rupiah rapidly depreciated instead. This was in large part because foreign creditors began to reduce
their exposure to Indonesia, and large domestic conglomerates, fearful that they would not be able to repay their foreign debts if the rupiah fell significantly, rushed to hedge these debts by buying US dollars. In fact, as unhedged domestic borrowers jumped into the market to try to cover their positions, this pushed the rupiah even further downward. By July 21 the rupiah fell by 7 per cent, in effect sharply depreciating to near the bottom of the new band. This only made domestic capital flee to safer havens offshore. In response, on July 23, Bank Indonesia raised interest rates from 12 per cent to 13 per cent, and intervened heavily in support of the rupiah. But this was to no avail, as the panic selling of rupiah and assets denominated in rupiah continued. When the rupiah depreciated by 13 per cent (from 2,400 per US dollar in July to 2,700 on the August 13), it was the last straw.

On August 14, the Indonesian authorities, reluctant to squander more foreign reserves, allowed the rupiah to float. Immediately the rupiah depreciated sharply against the US dollar and other currencies in which the Indonesian banks had borrowed. As the currency depreciated, the rupiah-denominated value of the interest and amortization of foreign debts surged, causing a serious balance-sheet problem in both the corporate and banking sectors. In particular, because of the depreciation, the amounts of rupiah that Indonesian banks earned on their long-term loans to the property sector and other industries were no longer sufficient to service their short-term foreign borrowing. Moreover, the banks could no longer attract new funds from abroad that could be used to repay the short-term borrowing coming close to maturation. In response, the Indonesian government raised short-term rupiah interest rates in order to attract rupiah deposits and stabilize the currency. For example, on August 11, 1997, the overnight Jakarta inter-bank rupiah rate (or JIBOR) was 15.8 per cent. A week later, on August 18, the overnight JIBOR was 51.4 per cent, and by August 22, the overnight JIBOR was 87.7 per cent. However this failed to bring much reprieve, as the rupiah continued to weaken. The Ministry of Finance responded by cutting government spending by rescheduling projects worth about US$16 billion and limiting routine expenditures on non-priority items (Pincus and Ramli 1998, 725). It also further tightened liquidity by instructing the public sector (including state-owned enterprises) to shift their deposits from (mainly state-owned) commercial banks to Bank Indonesia. However, this also proved ineffective, as the rupiah continued to slide – gaining renewed momentum downward on August 21. In desperation, on 29 August, Bank Indonesia issued a new rule limiting the forward sale of dollars to non-residents to US$5 million in order to reduce currency speculation.

It is not clear if the Indonesian authorities were in consultation with the IMF regarding the tight money policy. Bank Indonesia argued that the tight money policy was necessary to keep inflation under control and to stem the tide of large shifts into dollar holdings by residents. This is similar to the long-held IMF position that stresses the importance of high interest rates in
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keeping domestic currency holdings attractive, even if this complicates the situation of weak banks. In hindsight, an “overshoot” in the interest rate rise, through the tightening of liquidity by the Indonesian authorities, was very much responsible for the severe financial crisis that ensued. More than anything else, the tight money immediately exposed Indonesia’s weak financial and banking systems. Bank runs emerged as early as the second half of August 1999, when the process of “flight to safety” began. Faced with the prospect of widespread bank failures, Bank Indonesia had to scramble quickly to supply banks facing liquidity problems with funds, and by the end of August 1997 had put up some US$500 million for the troubled banks (Soesastro and Basri 1998, 9).

The injection of new liquidity and the lowering of short-term interest rates (the JIBOR rate fell to 40 per cent in the first week of September) did provide temporary reprieve. On September 23, the finance minister Mar’ie Muhammad unveiled a comprehensive policy program to deal with the crisis (Muhammad 1997). The program included: (a) stabilization of the rupiah at a new equilibrium level; (b) strengthening of fiscal policies and fiscal consolidation; (c) reduction of the current account deficit; (d) strengthening of the banking sector; and (e) strengthening of the private corporate sector. To achieve these objectives, the government made a pledge further to “loosen liquidity gradually and in accordance with the situation through fiscal and monetary instruments.” Furthermore, the government made a commitment to reduce interest rates and to cancel or postpone over 200 public sector-related development projects that would save the government some US$37 billion. These included the postponement of costly mega-projects such as the construction of the Jakarta Tower, of the bridge between Sumatra and the Malaysian peninsula, and of the Menara Jakarta bridge. With regard to the banking sector, the government announced its intention to merge state banks and liquidate the insolvent ones. Also, it made a commitment to follow up quickly on the plan to encourage weak private banks to explore the possibility of mergers. Finally, in a dramatic move, the 49 per cent foreign ownership limit on Indonesian stocks was scrapped in order to increase foreign investment in the stock market.

These announcements succeeded in bringing a measure of calm to the markets. As the rupiah stabilized around Rp. 3,000 per US dollar some thought that the worst was over. However, it was only a temporary reprieve – the calm before the storm. Part of the dilemma was that Indonesia was facing a confidence problem, and despite all the concerted effort, the government failed to restore confidence. However, a bigger problem was that, ambitious as the finance ministry’s program was, it did not go far enough. For example, rather than postponing or dismantling inefficient and profligate monopolies, such as the Suharto protégé, Bacharuddin Jusuf Habibie’s, pet project, the state-owned aircraft manufacturer Industri Pesawat Terbang Nusantara (IPTN), or the national car project owned largely by Suharto’s
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youngest son, the government reaffirmed its commitment to continue to support these projects. Equally blatant was the government’s approval of the 1,350 megawatt Tanjung Jati C power plant (in which Suharto’s daughter, Tutut, had a major stake), when the Java–Bali power grid was facing up to 70 per cent over-capacity (Tan 2000, 172; also Eklof 1999, 101). As regional currencies and stock markets continued to plummet, and amidst reports that Indonesian banks and private companies were having great difficulty in meeting their external debt-service obligations, the pressure on the rupiah re-intensified. By early October the rupiah had fallen by more than 40 per cent since July (the fastest depreciation among the crisis countries), while the Jakarta Stock Market Index dropped by 44 per cent (Soesastro and Basri 1998, 10). On October 6, the Indonesian government sold another US$650 million in the foreign-exchange market to stabilize the external value of the rupiah (Nasution 1999, 88). Again, this was to no avail. On October 8, when the exchange rate passed 3,800 rupiah to the US dollar, Indonesia turned to the IMF for “consultation and technical assistance.”

On October 31 (after some three weeks of discussions), the Indonesian government negotiated a financial bailout package totaling some US$43 billion in international assistance with the IMF and bilateral donors. The package consisted of US$23 billion of the so-called “first line of funds” negotiated with the IMF and a “second line of funds” negotiated with bilateral donors. These included Japan (US$5 billion), Singapore (US$5 billion), United States (US$3 billion), Malaysia (US$1 billion), Australia (US$1 billion), Brunei (US$1.2 billion) and China and Hong Kong SAR. Of the US$10 billion from the IMF, US$3 billion was to be disbursed immediately, and a further US$3 billion was to be made available after March 15, 1998, provided the Indonesian government met the program’s economic targets. The rest of the money was to be disbursed on a quarterly basis, provided the targets continued to be met (IMF 1997c). The entire agreement was to be implemented over a three-year period and carefully monitored jointly by the Indonesian government and the IMF, including experts from the World Bank and the Asian Development Bank.

The mood was one of cautious optimism after the signing of the October 31 agreement. It was widely believed that the agreement would restore investor confidence and arrest the rupiah’s continuing plunge. The IMF Managing Director, Michel Camdessus, summed up the prevailing mood when he noted that “these measures should restore confidence in the Indonesian economy and contribute to the stabilization of regional financial markets” (IMF 1997b, 3). Indeed, initially the program received positive response from the market, resulting in the rupiah strengthening from Rp. 3,700 to Rp. 3,200 per dollar. However, it was too early to celebrate. The economic program the Indonesian government had committed to in its “letter of intent” to the IMF (which now became part of the agreement) was quite extensive, given the IMF’s objectives of restoring market confidence
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via restricting aggregate demand by raising interest rates and cutting the budget, and improving the real sector's efficiency by eliminating monopolies. Thus the program included, among other things (a) trade policy reform, in particular, trade deregulation for various commodities via the elimination of the monopoly of BULOG (Badan Urusan Logistik – Food Distribution Agency) on the import of wheat, wheat flour, soybeans and garlic, effective January 1, 1998; (b) a gradual reduction of import tariffs on chemical products, iron and steel, and fisheries products; (c) industrial policy reforms such as the elimination of the local content program for automobiles by 2000 and the implementation of the WTO decision on the National Car project by 2000; and (d) macroeconomic policy targets for economic growth, the inflation rate, the current account deficit and fiscal balance, as well as economic reform measures covering investment and financial institutions (IMF 1997e). At the core of this last was the program to reform the banking industry.

Specifically, on the basis of data made available by Bank Indonesia on the financial condition of 92 of the 238 banks, representing 85 per cent of the assets of the banking system, the IMF and the Indonesian government agreed on a comprehensive bank resolution package consisting of:

1. intensified supervision, including frequent and detailed reviews, in addition to daily monitoring of key elements like liquidity and foreign exchange exposure for six of the country's largest private banks (market share: 18 per cent) in which some critical weaknesses had been identified;
2. rehabilitation plans for seven small private banks;
3. conservatorship for three small, severely under-capitalized private banks, and for six insolvent regional development banks (market share 0.4 per cent);
4. transfer of the performing assets for two insolvent state-owned banks (market share: 9.6 per cent) to a third state-owned bank; merger of the two insolvent banks and transformation of the resulting entity into an asset-recovery agency;
5. definition and implementation of rehabilitation plans for 10 insolvent private banks (market share: 3 per cent) that had benefited from a Bank Indonesia-sponsored and legally binding rescue package prior to the crisis, accelerating their return to solvency; and
6. closure of 16 small and deeply insolvent private banks (market share: 2.5 per cent), with protection limited to small depositors, or those with deposits of up to 20 million rupiah (around US$6,000). Indeed, the IMF press release stated that the Indonesian authorities “are determined that only a small portion of the costs of the restructuring will be met from the public purse. The government will compensate small depositors only, and not private shareholders and creditors. The government will not guarantee any liabilities of private non-financial companies, domestic or foreign” (IMF 1997e, 2).
In total, the agreement included 50 banks, representing 34.3 per cent of the banking system. However, on November 1, 1997 (less than 24 hours after reaching the agreement with the IMF), the Indonesian government abruptly suspended the operating licenses of 16 banks – in effect, closing them down. Among the closed banks, two were partly owned by Suharto’s son and half-brother. Although the government hoped that its decisive action would be interpreted by the public as showing that the authorities were finally serious about reforming the banking sector, the outcome was quite the opposite. In short, the action proved to be disastrous. As Soesastro and Basri (1998, 19) note, “the closure of 16 commercial banks created panic in the country, leading to large withdrawals by depositors even from banks that were generally believed to be healthy.” Suddenly, confidence in domestic private banks was shattered. As a result there was further “flight to quality,” as depositors sought to move their funds out of the private banks that were believed to be in trouble into the state banks, which were widely thought to be more secure. Literally overnight, many banks lost their deposit base, besides finding that trade and other financial lines from their bank business abroad were terminated. Letters of credit issued by many Indonesian banks were no longer accepted overseas (Djiwandono 1999a, 148). It seemed that market confidence had been completely lost.

Why did the closure of just 16 small and insolvent banks with only 2.5 per cent of the total banking assets generate such a panic?

According to Sachs (1997), the reason was the IMF’s “misguided policies.” He claims that the closure of the banks was not necessary. By hastily closing banks in an environment where no deposit insurance was in place, the IMF generated panic that quickly became a full-blown financial crisis. Indeed, the closures exacerbated the ongoing liquidity squeeze in financial markets, making it much more difficult for all banks to continue their normal lending operations. Yet it is also important to recognize that Sachs is only partly correct, and the IMF only partly to blame for Indonesia’s financial crisis.

While there is little question that pressure from the IMF forced the Indonesian government to take its first significant step toward restructuring the banking sector (by liquidating 16 of the weakest private banks), the problem was not the closure of these weak banks per se, but the manner in which this was brought about. First, while the agreement mentioned 50 banks, only 16 were closed – and these 16 were clearly insolvent on the basis of data provided by the banks to Bank Indonesia. Since the remaining 34 banks were not identified, the move created uncertainty among the general public regarding the fate of all other banks. After all, not only was the public generally aware that some well-connected banks were not listed, but the IMF’s initial program failed to make provisions for a deposit insurance. Suffice it to note that under such uncertainty even rumors about a bank’s solvency could spark a bank run. Second, the abrupt closure of banks in the...
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midst of very volatile capital withdrawals and without a comprehensive and well-thought-out financial restructuring plan in place only added to the panic. Third, there was no strategy in place for dealing with the liabilities and assets (both good and bad) of either the closed banks or those that remained open. This lack of disclosure regarding the health of remaining banks further fueled depositor concerns about the overall health of the banking sector. Indeed, as it turned out, the depositors’ initial concern soon ballooned and initiated a full-scale run on the banking system. As Azis (1999, 81) notes, “even with 15 to 20 per cent higher interest rates in the remaining local banks, most depositors went in a panic to the foreign banks operating in Jakarta.” This dramatic move therefore only served further to undermine the banking system as a whole.

Fourth, among the 16 banks listed for closure were Bank Andromeda (of which 25 per cent was owned by one of Suharto’s sons, Bambang Trihatmodjo), Bank Jakarta (partly owned by Suharto’s half-brother, Probosutejo), and Bank Industri (owned by Suharto’s daughter, Siti Hedi janti Herijadi and Hashim Djohadikusumo, her brother-in-law. These banks included the smallest and weakest banks in the country – with less than 2.5 per cent of Indonesia’s total banking assets. Their plans for closure failed to generate public confidence – despite the fact that the government announced it would protect small depositors by guaranteeing all deposits up to 20 million rupiah. But on the contrary, the public, including foreign investors, cognizant of the fact that these 16 closures would hardly have a significant impact on the health of the banking system as a whole, braced themselves for more bank closures. More importantly, the deposit guarantee proved woefully insufficient to generate confidence. Domestic investors transferred deposits from private banks to state banks, in a flight from quality to safety. Many also transferred funds to foreign banks, or exchanged rupiah for dollars and repatriated their funds. Blustein (2001, 107) sharply observes the unfolding of the panic:

toward the end of the first week of November, the reaction to the bank closures took an ominous turn. Anonymous lists of “good banks” and “bad banks” began circulating around Jakarta . . . Before long, a full-fledged run on privately owned banks was under way. Bearing bags and boxes to hold cash, crowds thronged to withdraw their deposits from branches of the giant Bank Central Asia, owned by Suharto’s pal Liem Sioe Liong, in the second week of November. Many depositors rushed their money from private banks to state-owned banks, figuring the state-owned ones, whatever their problems, were at least backed by the government; others showed up with bags of rupiah to deposit at the Jakarta branches of Citibank and other foreign institutions.

Fifth, the situation was made worse when Bambang Trihatmodjo (on November 5) filed a lawsuit against the Governor of Bank Indonesia and the Minister of Finance over the closure of his Bank Andromeda.25 The fact that Bank Andromeda was back in operation in no time – under the
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name of Bank Alfa (but using the same building and employees and a new foreign exchange license issued by Bank Indonesia), and that several of the earlier-canceled “development” projects of Suharto’s family and cronies were soon suddenly back in operation, convinced many that Suharto was intent on protecting his family’s business and commercial interests at all costs, and that the regime was not serious about implementing the agreed reforms.26 This perception was only confirmed when large deposit withdrawals from private banks prompted the central bank to issue emergency credits in ever-increasing amounts to ensure that these banks did not go under. Some of these huge lines of credit were channeled to banks owned by the well-connected. Thus, rather than instilling fresh confidence in the banking system, these developments caused further panic withdrawals of deposits from most private banks.

What is then the final verdict on the initial IMF policies? First, the sudden bank closures of November 1, which precipitated the general loss of confidence in the banking system, were conducted under IMF direction. There is also no doubt that the IMF gravely mis-diagnosed the problem by perceiving the crisis as a limited banking problem affecting only a small number of banks. More broadly, the IMF’s prescription of a fiscal surplus was seemingly based on the premises of a profligate public sector and high inflation – neither of which was accurate. Nor did the demand for tighter fiscal and monetary policy when budgets were broadly in balance, and when the economy was already beginning to contract, make sense. Hill (1999, 52–3), aptly blames the IMF’s “scatter-gun” approach, which “overloaded the reform agenda, forcing bureaucratically stretched governments to quickly tackle a vast array of highly complex and sensitive policy issues” and when it “attempted to resolve banking sector distress too quickly, aggravated the general loss of confidence.” The IMF should have known that reforms requiring fundamental legal and institutional change take months, if not years, to implement effectively.

From late November onwards, things began to go seriously wrong. For a start, the extent of the private sector foreign debt was revealed to be much larger than most analysts had realized.27 The vast majority of the Indonesian firms and financial institutions previously thought sound had a large debt burden in foreign currencies that they could not service from their rupiah earnings at the prevailing unfavorable exchange rate. Specifically, they had failed to take the prudent step of hedging themselves against a drop in the rupiah by purchasing contracts in the currency markets ensuring that they would be able to obtain dollars at a reasonable rate.28 These entities were now effectively bankrupt. Furthermore, as the international financial markets lost confidence in Indonesian banks they refused to roll over short-term debt and accept letters of credit. Also, the government decision to limit access to foreign borrowings and to shift public sector deposits from (mainly state-owned) commercial banks to the central bank squeezed
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liquidity. With banks suddenly illiquid, default by corporate borrowers increased. In this capricious and unpredictable environment, bank deposit runs multiplied amid rumors that a new wave of bank closures was under preparation. By mid-December, 154 banks, representing half of the total assets of the system, had faced, to varying degrees, some erosion of their deposit base (Enoch et al. 2001, 31). Also, during December 1997, Bank Indonesia’s liquidity support (in the form of Bantuan Likuiditas Bank Indonesia or BLBI) increased from 13 trillion rupiah to 31 trillion rupiah, equivalent to 5–7 per cent of GDP (Lindgren et al. 1999). In so far as the liquidity support, paid in rupiah, was needed by banks to meet reductions in dollar deposits, in effect it served to fuel capital flight and, thus, the continuing depreciation of the exchange rate. In contrast to the situations in other crisis-hit countries, in Indonesia efforts at sterilization were not successful, reflecting a loss of monetary control by Bank Indonesia. By late December, the rupiah was fluctuating in a wide range around Rp. 5,000 to 6,000 per US dollar.

The banking crisis becomes systemic

On January 6, 1998, President Suharto presented to the Parliament a draft budget for the fiscal year 1998/99. The proposed budget totaled Rp. 133 trillion, a 32.1 per cent increase as compared to the preceding year’s budget of Rp. 101 trillion. The draft budget was based on the “balanced budget” principle (which limits the size of budget deficit to the level that can be financed by foreign aid and loans), and calculated on the basis of certain assumptions about future conditions, such as a particular exchange rate (Rp. 4000 per US$1), an annual economic rate of growth of 4 per cent, and an inflation rate of 9 per cent. The budget also failed to produce the surplus of 1 per cent as stipulated in the IMF agreement. In fact, the expansionary budget was in direct contravention of IMF requirements for a 1 per cent budget surplus. Almost immediately, the markets reacted negatively to the “unrealistic” expansionary budget.

As questions about Suharto’s commitment to implementing the program once again came to the forefront, the rupiah headed into a free fall. From Rp. 5.450 per US$1 on January 1, it dropped to 6,000 per dollar on January 2 – which put the value of the rupiah 60 per cent below its level of the preceding summer. Then came the infamous “black Thursday” on January 8, when the rupiah fell below the “psychological threshold” of Rp. 10,000 to US$1 – leading to panic food buying and social unrest. In desperation, Suharto hinted at the possibility of issuing Indonesian dollar banknotes that could replace real dollars and be put in a special dollar deposit with high interest rates. The president’s daughter, Siti Hardijanti Rukmana (Tutut), promoted Gerakan Cinta Rupiah or “Getar” (the “we love the rupiah movement”), to encourage citizens to change their cash dollar holdings into rupiah.
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Their desperation was cruelly displayed when Tutut and Suharto coordinated the campaign with a racially-tinged attack on the prominent *non-pribumi* (Chinese-Indonesian) businessman, Sofyan Wanandi, after he refused to go along with the campaign. In the end the initiative was to no avail. The value of the rupiah continued to slide, reaching Rp. 10,200 to US$1 on 11 January 1998. Compounding the growing disarray was the sudden collapse (on January 13, 1998) of Peregrine Investment Holdings – Asia’s largest home-grown investment bank outside Japan. The immediate cause of the Hong Kong-based Peregrine’s insolvency was its exposure to over US$400 million in Indonesian corporate debt. However, Peregrine’s largest exposure was its underwriting a loan of US$236 million (which amounted to about one-third of its equity) to PT Steady Safe, a local taxi company in Jakarta. It seemed that the bottom had fallen out of the Indonesian economy. Fearing that worse was yet to come, ordinary Indonesians went on a rampage of panic buying of every available food commodity as rumors grew that a ban on food imports and large-scale rationing might be imposed at any time to save the country’s rapidly falling currency. Under these circumstances, and subjected to growing pressure from “an array of heads of state – from Washington, Tokyo and Canberra,” including the “US president urging Suharto to work with Michel Camdessus, who was due to arrive in Jakarta the following week,” the Indonesian government had little choice but to concede to the IMF (Azis 1999, 85; Blustein 2001, 208).

On January 15, 1998 in a nationally televised official ceremony witnessed by the IMF managing director Michel Camdessus (who stood imperiously over the president), Suharto signed the second “Letter of Intent” with the IMF, politely acceding to all the IMF’s demands. Labeled a “much strengthened program” by Camdessus, it was clear that the IMF’s second reform program was able to extract a far greater range of reform commitments from Suharto. Specifically, as stated in the letter of intent, the Indonesian government pledged to implement a 50-point “Memorandum of Economic and Financial Policies” agreed with the IMF (1998a, 1998b). The program included provisions such as, on fiscal policy, calling for the revision of the draft budget for fiscal 1998/99. However, it should be noted that the IMF recognized that, with the sharp depreciation of the rupiah and the deterioration in the economy, it was no longer feasible to aim at a surplus of 1 per cent of GDP – it relaxed its monetary policy stance by settling for a deficit, at 1 per cent of GDP. This was to be achieved via expenditure reduction, namely, the elimination of fuel and electricity subsidies. Non-budget expenditures such as the investment fund and the reforestation fund were to be incorporated into the central government budget. Regarding public sector projects, the program called for “canceling immediately the 12 infrastructure projects that were recently postponed or placed under review. Moreover, budgetary and extra-budgetary support and credit privileges granted to IPTN’s airplane projects will be discontinued, effective immediately. In
addition, all special tax, customs, and credit privileges for the National Car project will be revoked, effective immediately.” The program also made it clear that Bank Indonesia should continue to adopt a tight monetary policy, and must be “given full autonomy to conduct monetary policy, and start immediately to unilaterally decide interest rates on its SBI [central bank] certificates.”37 In order to improve domestic competition, the program required cartel-like marketing arrangements, including those of the Indonesian Plywood Association (APKINDO) monopoly over plywood exports and the existing monopolies over the import and distribution of sugar, wheat flour, cement, paper and steel to be eliminated by February 1. The Clove Marketing Board was to be eliminated by June 1998. This meant that “from February 1, 1998 BULOG’s monopoly will be limited solely to rice.” On investment and foreign trade, the program called for the elimination of restrictions on foreign investment in palm oil and wholesale and retail trade, and of content regulations and export taxes on a wide range of products, including leather, cork, ores, logs, sawn lumber, rattan and minerals. Finally, it called for the deregulation and privatization of selected state-owned enterprises and strategic industries.

Despite the seemingly comprehensive nature of the reform package, it failed to restore market confidence. On the contrary, the rupiah fell 6.5 per cent against the US dollar the very day the second letter of intent was signed, and by another 5.4 per cent the following day. According to the IMF the problem was that currency traders and investors were skeptical that the wide-ranging measures would be implemented by Suharto. The widely held (and generally correct) perception was that the wily Suharto had signed up to the program only reluctantly, and that he did not intend to follow through with a program that would hurt the business interests and the vast financial empire controlled by his children (estimated to be worth around US$30 billion),39 and the interests of his close associates (Eklof 1999, 126–7). In fact, even before the IMF team had left Jakarta, one could sense the growing rift between the IMF and the Suharto regime. Suharto began sending mixed signals regarding his commitment to the program. According to Soesastro (2000, 132), “confidence was further weakened because the government, the President in particular, did not show any will to implement the agreement with the IMF in good faith.” Similarly, Winters (2000, 46) notes that “Suharto quietly reneged on most of what he had agreed to in public.”39 Indeed, in an act of open defiance, Suharto made it public that he wanted his long-time friend and the big-spending Technology Minister, B. J. Habibie, as his vice-presidential candidate (and presumed successor) in the upcoming March polls – in spite of the well-known antipathy towards Habibie within the IMF and the international financial community.40

Yet the IMF’s policies must share part of the blame. Specifically, the wide-ranging character of the Fund’s policy, and in particular, its zealous aim
of including as many structural reform measures as possible in its programs, did little to shore up market confidence. Radelet (1999) aptly notes that the new IMF program, which eased up slightly on fiscal policy and on the capital adequacy ratio required for banks, but otherwise kept the same basic strategy as the first policy, was misguided. That is, since excess demand was not at the root of Indonesia’s problems, and the capital withdrawals well under way meant that the economy was already contracting significantly, the initial fiscal tightening simply added to the contraction, further undermining investor confidence and fueling capital flight. Also, the structural reforms envisaged in the program, while necessary over the long term, did not provide any concrete solutions to the immediate problems of the banking and currency crisis. Indeed, the most often-cited complaint about the IMF program was that it lacked a clear plan for dealing with the primary source of worry about the rupiah – the increasingly crippling foreign debt of Indonesian companies. Furthermore, the program did not articulate a clear strategy to resolve the banking sector problems (i.e. it did not contain concrete bank rehabilitation and restructuring measures that could restore confidence in the banking system), nor did it provide a plan to deal with Indonesia’s mushrooming short-term foreign debt. The market’s lack of confidence was reflected in the continued downhill slide of the rupiah. Less than a week after the signing ceremony between the IMF and Suharto, the rupiah fell to an unprecedented all-time low of Rp. 17,000 to the US dollar on January 22. Also, left unattended, the banking sector problems turned into a full-fledged systemic crisis, with liquidity support from Bank Indonesia exceeding over 60 trillion rupiah (about 6 per cent of 1998 GDP), with the risk of hyperinflation and complete financial sector meltdown looming menacingly on the horizon.

Finally, on January 27, 1998, with their backs against the wall, both the IMF and the Indonesian government took steps to deal with the banking sector problems. Finance Minister Mar’ie Muhammad announced a three-point emergency plan. First, in response to depositor panic and the refusal of international banks to accept letters of credit issued by Indonesian banks, Bank Indonesia announced a blanket guarantee of the rupiah and foreign currency denominated debts of all domestically incorporated banks for two years – effectively assuming banking sector risk. The guarantee extended to deposits and most types of creditor claims, excluding subordinated debt. The blanket guarantee on deposits (confirming Bank Indonesia’s determination to exercise its last-resort function even if this exacted a heavy toll), was designed to stem bank runs and thereby stabilize the banking system. The IMF, which had been resisting a government guarantee on bank deposits since late 1997 (because of concerns regarding moral hazard), relented, since the bank runs were so devastating. In addition, Bank Indonesia placed restrictions on credit growth and announced it would set weekly ceilings on the maximum interest rates that banks could pay on deposits.
Second, a new regulatory public body for the banking industry, the Indonesian Bank Restructuring Agency (IBRA) was established under a presidential decree for a period of five years, under the auspices of the Ministry of Finance. Established as an “independent agency, reporting to the Ministry of Finance” (but with advisors from the New York-based investment banks Lehman Brothers and JP Morgan), IBRA’s task was to take over and rehabilitate weak banks and administer the government’s guarantee program for bank debts. IBRA was also empowered to establish a separate asset-management entity called the Asset Management Unit (AMU) to take over non-performing assets from banks that were either to be liquidated or merged into stronger institutions. The loan-recovery plans were to involve a variety of methods, including collection, loan workouts and packaging of the loans for sale to third parties. The rationale for transferring these assets to the AMU was that, by disposing of the burden of problem loans on management and financial resources, the surviving banks would be in a better position to provide new credit to the market, besides becoming more attractive propositions to new investors. Furthermore, not only was the Banking Law amended to give the AMU the power needed to deal with problem banks, but all banks were required to have their loan portfolios reviewed by internationally recognized audit firms by the end of 1998. Also, IBRA was given the responsibility for collecting from the majority shareholders of the private banks the amounts that their banks owed Bank Indonesia in connection with the liquidity support that they had received. Third, a framework for handling corporate restructuring was proposed: in particular, the plan recommended a temporary voluntary suspension of corporate external debt payment. However, the government made it clear that there would be no use of public financing, guarantee or subsidy to bail out the debt and reimburse unguaranteed creditors looking for financial redress.

However, IBRA was hardly an autonomous agency. In fact, the agency not only “had to operate subject to intense political oversight, its effectiveness was compromised by a weak legal and regulatory framework and its need to obtain political authority, even for technical operations” (Enoch et al. 2001, 15). Nevertheless, the fact that IBRA’s restructuring agenda looked feasible raised hopes that finally something substantive was being done to deal with the country’s banking problems. On the basis of its review of the banks’ financial position, IBRA divided banks that had received substantial liquidity support from Bank Indonesia (i.e. more than 500 per cent of their total equity) into categories A and B. Category A banks included those that had received liquidity support equal to or in excess of 75 per cent of their total assets, and Category B banks were those that had received less than 75 per cent, but in sums still equal to or in excess of two trillion rupiah. Category A banks were to be liquidated, whereas Category B banks were to have the rights of their shareholders suspended and their existing managers replaced by IBRA – which would assume full management control. IBRA
also made it explicit that the former majority shareholders of the suspended banks should pay the government two separate amounts: first, the outstanding negative balance that their bank had accumulated with Bank Indonesia, and second, the amount by which their bank’s intra-group lending exceeded the affiliated lending limits before September 21, 1998 (Witcher and Solomon 1998). The announcement of this new and ambitious plan was able to slow bank runs and restore a modicum of financial stability. On January 28, the exchange rate recovered to Rp. 12,500 per US dollar, and appreciated further in the subsequent days to rally at Rp. 9,950 per US dollar on February 16. IBRA’s early actions resulted in the closure of a large number of banks that had severely negative net worth and no significant value or franchise importance to the system. Specifically, by 14 February, 54 distressed banks (consisting of 4 state banks, 39 private national banks and 11 regional development banks, comprising 36.7 per cent of the banking sector), that had borrowed heavily from Bank Indonesia were brought under the auspices of the IBRA. The four state-owned banks (Bapindo, Bank Bumi Daya, Bank Dagang Negara or BDNI and Bank Exim), accounted for 24.7 per cent of the liabilities of the banking sector (Lindgren et al. 1999, 59).

However, just when the government’s plan seem to be working – making believers of some of the cynics – interference by Suharto and his cronies once again undermined the efforts (Sadli 1999). Enoch and his co-authors (2001, 14) note that “the restructuring process created a permanent tension between its [IBRA’s] officials and the wider political forces whose interests were likely to be threatened. As the extent of the necessary restructuring became apparent, these tensions increased.” First, Suharto refused to publicize the operations of IBRA. As a result, IBRA officials had to work over the following weeks against a public perception that IBRA was a “paper tiger” and still not operational (Enoch et al. 2001, 33). As the IMF study reports, “the initial workings of IBRA were not apparent to the public, there was confusion as to the authorities’ intentions, and the momentum generated by the January 27 announcement was largely lost” (Lindgren et al. 1999, 59). More damaging, on February 17, Suharto abruptly fired one of the few reformers in his regime, the highly respected Governor of Bank Indonesia, Sudradjad Djiwandono, less than two weeks before the official end of his tenure. It was reported that Suharto fired Djiwandono after the governor “had argued that Suharto was about to subvert an economic recovery plan he reluctantly signed just last month with the IMF” (Sanger 1998). In late February, Suharto dismissed the head of IBRA, the highly regarded senior finance ministry official, Dr Bambang Subianto, after only a month in the job, “reportedly for being too diligent in pursuing his responsibilities” (Enoch et al. 2001, 15). To make matters worse, Suharto started making increasingly hostile remarks about the IMF, culminating in a reported statement to a largely Muslim audience that the IMF package could not be implemented because it violated Article 33 of the Indonesian
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constitution. If Suharto’s obscurantism and well-worn pattern of double-entendres and half-measures frustrated the IMF and the donor countries, his plan (which according to Soesastro (2000, 133) was conceived “clearly on the advice of his children”), to create a fixed exchange-rate system for the volatile rupiah through a currency board in direct opposition to the IMF, the United States, the European Community, Japan and other donor governments, was more than could be tolerated.

While rumors that Indonesia might adopt a currency board had been around for weeks, by mid-February Jakarta began to send implicit messages that it would unilaterally establish a currency board, unless the Fund came up with a better alternative for strengthening the rupiah. On February 11, the minister of finance announced that the government was preparing steps towards setting up a currency board system – by the end of February at the latest. Following the appointment on February 17 of the US trained economist, Sjahrl Sabirin, as the new Bank Indonesia Governor, and the strong currency-board advocate and Johns Hopkins University economist Steven Hanke (who was named advisor to President Suharto’s economic council), the Indonesian government embarked on a media blitz to make its case for a currency board regime. The government now claimed that, unlike an ordinary exchange-rate peg, the predictability and rule-based nature of a currency board would impose strict discipline on the government – preventing it, for example, from abusing the central bank’s printing presses to fund large deficits. Using the example of the Hong Kong dollar (which had been officially fixed at HK$7.80 per American dollar since the board was introduced in 1983, and had weathered the crisis reasonably well), supporters argued that since the currency board holds extremely low-risk interest-bearing bonds and other assets denominated in the anchor currency, it not only encourages arbitrage, but also offers an effective barrier against speculative attacks and rapid currency appreciations. Moreover, they claimed that currency boards provide stability to the banking and financial system by maintaining market-adjusted interest rates and prudentially controlling destabilizing international capital flows.

Indeed, at first glance, Indonesia seemed to be a strong candidate for a currency-board arrangement. Such an arrangement would replace the existing regime that permitted Bank Indonesia wide operational discretion with a rules-based system. No doubt, under a currency-board system, a number of controversial operations (in particular, the provision of liquidity to the banks), would be severely curtailed or prohibited. After all, several countries, most notably Argentina and Bulgaria, had recently introduced successful currency-board systems to deal with problems similar to those that Indonesia was facing. While the IMF in principle is not opposed to emerging economies’ establishing currency boards, it strongly opposed the Indonesian plan (threatening to withhold funding) because it felt that a currency board was a “quick-fix and ultimately unsustainable solution for
Rather, the IMF argued that it was important for Indonesia to implement the agreed-upon reforms before establishing a currency board. This meant that, although the IMF supported the objective of achieving an appreciation of the exchange rate, it argued that this had to be achieved by a comprehensive macroeconomic and financial program. This was based on sound economic reasoning: a currency-board arrangement can only work effectively if the banking system has the capacity to tolerate significant movements in domestic interest rates. Without this capacity, the currency-board arrangement will induce a conversion of deposits into foreign exchange, further shrink the monetary base and greatly increase interest rates. Since a currency board must hold reserves of foreign exchange (or gold or some other liquid asset) equal at the fixed rate of exchange to at least 100 per cent of the domestic currency issued, the IMF appropriately concluded that Indonesia’s US$12 billion in disclosed foreign-exchange reserves (as of March 20, 1998), and a foreign debt of $130 billion were simply inadequate to back the estimated 24 trillion rupiah in circulation – for a board system would drain the reserves in a few weeks, if not days (Tesoro 1998b).

Moreover, the IMF had good reason to suspect that the Suharto regime would dip into the loans to support the currency board – after all, it was already injecting massive doses of liquidity to bail out the country’s weak banking system. The IMF correctly found the Hong Kong example to be spurious. As was noted in the introductory chapter, in Hong Kong, the Exchange Fund is committed to 100 per cent foreign-currency backing for Hong Kong dollar bank notes, and the Hong Kong Monetary Authority (HKMA) has an explicit mandate to act as an official lender of last resort, and has been involved in open-market operations since 1990. Also, Hong Kong (unlike Indonesia) has formidable foreign reserves, totaling over US$85 billion (in 1997–98), to cover the currency in circulation plus demand deposits. This gives the HKMA tremendous autonomy to raise short-term interest rates to make it expensive for speculators to obtain Hong Kong dollar credit. Unlike Indonesia’s banks, Hong Kong’s well regulated and capitalized banks, with very low levels of non-performing loans, could cope with the increases in short-term interest rates that might be needed to defend the currency board. In addition, with justifiable reason, the Fund remained highly suspicious of the “Suharto plan” under which the rupiah’s rate would be 5,000 to the dollar, or about twice as strong as the then current rate. That is, with the rupiah trading at around 8,000 rupiah to the US dollar at the time of the announcement, the proposal involved an appreciation of around 40 per cent – essentially by administrative fiat. Needless to say, such a move would hardly be credible to the markets. Finally, since a currency board is committed to exchanging on demand and without any limit, foreign currency and local currency, and in some cases must also exchange bank reserves at a pre-announced exchange rate, the IMF felt that the currency board was a ploy to allow Suharto’s children and cronies to retrench their
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discretionary and egregious rent-seeking structures and quickly change their substantial rupiah holdings into dollars at an artificially high rate and then move those funds into offshore accounts. It should be noted that, if capital outflows are sufficiently large, a currency board could collapse because of a shortage of foreign assets. In Indonesia, where the government in 1997–98 could not even provide complete cover for the domestic currency, the currency board would simply wipe out its remaining foreign-currency reserves before the entire domestic currency stock had been converted. In fact, some estimates indicated that if sustained capital flight did emerge after the pegging of the rupiah at 5,000 to the US dollar, the country would have reserves to defend the peg for less than one week (Enoch et al. 2001, 86).

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In the ensuing weeks, as the embattled Suharto vacillated and stalled, the economic downturn deepened and the Indonesian economy was brought to the brink of total collapse. Liquidity support to the banking sector continued to increase, in large part to meet continuing deposit withdrawals. This only further eroded the public confidence in the banking reforms under way. As tensions between Suharto and the IMF intensified, the White House dispatched (on March 3, 1998) the former US vice-president, Walter Mondale, to Indonesia to act as an intermediary between Suharto and the Fund. Yet this was to no avail (Blustein 2001, 230–2). Finally, the IMF’s managing director carried out what he had threatened in a leaked letter in mid-February. On 6 March, the IMF announced the suspension of the second installment of Indonesia’s bailout package (the second US$3 billion tranche), pending Suharto’s choice of a new cabinet (C. Johnson 1998, 27–8). Suharto responded on March 10. The People’s Consultative Assembly chose, by acclamation, Suharto as president and B. J. Habibie as vice-president.\textsuperscript{51} With the 77-year-old Suharto now set to serve an unprecedented seventh five-year term as president (ending in the year 2003), all hopes for an early resolution of the stalemate with the IMF were dashed. Indeed, in an open act of defiance to the IMF and bilateral donors (especially the United States), Suharto refused to appoint reformers to key cabinet positions. In fact, ministers who were seen to be sympathetic to the IMF reform program, such as the finance minister Mar’ie Muhammad, were dropped from the cabinet. Instead, Suharto choose to appoint a “crony cabinet” – chosen from a close circle of loyalists, including his eldest daughter, Tutut, and his long-time business crony and golf partner, Bob Hasan. Hasan was given the key trade and industry portfolio. Also, a close family and business associate, Fuad Bawazier, was given charge of the all-important finance portfolio, and a long-time crony, Tanri Abeng, the state enterprises portfolio.\textsuperscript{52} Several new ministers, including Hartono, minister of home affairs, and the labor
minister, Theo Sambuaga, were also appointed for their personal loyalty to Suharto and his children, not their competence. It seemed that the old corrupt establishment was trying to re-entrench itself for the long haul – despite increasing demands (both domestic and international) for reform.

With rising unemployment and skyrocketing prices of basic commodities (in large measure the result of reductions in government subsidies), thousands of Indonesians took to the street demanding Suharto’s ouster. Concerned about the potential chaos in the world’s fourth most populous nation, and still unwilling to give up on Suharto, President Clinton and the US Treasury encouraged the IMF to continue talking with Suharto. The third round of negotiations between the IMF and the Indonesian government began on March 17, amidst reports of widespread looting and rioting in several major cities and towns throughout the country. These developments seemed to convince the IMF of the need to adopt a more flexible approach in its negotiations, and in particular, it was persuaded into allowing BULOG to continue to retain the subsidies on basic commodities. For his part, Suharto quietly dropped the currency board idea by announcing that his government would “study” other alternatives. Thus it was in this context, in spite of the lingering hostility and mistrust, that the IMF and the Indonesian government reached their third agreement on April 9, 1998 (IMF 1998c). The new agreement reiterated the points agreed in the earlier ones, and added some more. Altogether, the “bullet-points” now totaled 117 specific requirements, including more specific targets and a timetable for implementation. On its part, the IMF announced that it would release its US$3 billion tranche to Indonesia – albeit, in portions of US$1 billion per month, rather than in its customary single total disbursement.

However, even before the ink was dry on the agreement, Suharto implicitly dismissed what he had just signed, calling instead for an undefined “IMF plus” program. The financial markets, however, having witnessed the drama before, failed to react to the agreement. Yet, the same could not be said of the rapidly growing popular opposition to Suharto’s rule. Following weeks of largely peaceful student demonstrations at dozens of universities across the country, events soon turned violent after a harsh crackdown by the security forces. The situation turned decidedly worse on May 4. On this day, as the IMF released its first US$1 billion monthly tranche, the Suharto government abruptly announced sharp increases in fuel prices, including a hefty 71 per cent for gasoline and 25 per cent for kerosene. Claiming wrongly that the price increases were mandated by the IMF, the Suharto regime hoped that the popular anger would be directed at the IMF. However, this gamble backfired. Instead, the call for Suharto’s resignation grew louder following the government’s ill-advised decision. In desperation, regime supporters, led by the Minister of the Interior Syarwan Hamid, blamed the price rise on non-pribumi ethnic Chinese (whom he called “rats disloyal to Indonesia”), as a result of their hoarding goods, thereby causing the sharp price hikes.
Between May 12 and May 17, the pent-up frustrations and racial tensions exploded. On May 12, some 20,000 students at Gajah Mada University in Yogyakarta protested, calling for Suharto’s resignation, and at Trisakti University in Jakarta, six student protesters were killed by soldiers. On May 13 a nationwide student protest quickly erupted in violence. Widespread violent rioting occurred simultaneously in many cities and towns throughout the country, and most tragically in Jakarta, where over a thousand people (mostly ethnic Chinese) were killed by mobs, reportedly organized and led by rogue elements of the Indonesian armed forces. In Jakarta alone some “5,000 buildings were damaged or burned and close to 2,000 vehicles were torched” (Azis 1999, 86). Suharto’s son-in-law, General Prabowo Subianto, head of the powerful kostrad (strategic military command based in Jakarta), tried to exploit the situation further with threats and claims that the military was fully behind Suharto (Emmerson 1999, 306–9). In this uncertain and chaotic environment expatriates, businesses and capital fled Indonesia – including the IMF and World Bank staffers based in Jakarta, who joined the exodus. On May 18 several thousand students occupied the parliament grounds demanding an immediate special session of the People’s Consultative Assembly and Suharto’s resignation. The students were joined by prominent opposition political leaders such as Dr Amien Rais and Professor Emil Salim – who openly supported the students’ demand for reformasi total, or total reform. By 3.30 in the afternoon, the Speaker of the House, Harmoko, flanked by two deputy speakers, announced that the parliamentary leaders were calling on Suharto to lengser kepabon (or step down) immediately for the sake of national unity (Anwar 1999, 34). However, hope faded as, later in the evening, General Wiranto, the head of the armed forces, announced that Harmoko had spoken as an individual and that his call for Suharto’s resignation had no legal authority.

Indeed, soon afterwards Suharto announced that he would not step down immediately. Instead, he promised to revise the political laws through a reform committee, the members of which would include representatives of the student protesters. In addition, Suharto announced that the cabinet would be reshuffled immediately, and the central task of the new kabinet reformasi (reform cabinet) would be to deal with the growing economic and political crisis. Finally, Suharto promised that new elections would be held as soon as possible. However, all this was too little too late. By May 20 (Indonesia’s National Day of Awakening), the number of students occupying the parliament grounds had swelled to over 30,000. On the morning of May 21 the Speaker of the parliament announced that all factions of parliament (including the military) were agreed that Suharto should resign immediately or face impeachment proceedings. Without the military’s backing, Suharto’s New Order was fundamentally and irrevocably damaged. Under intense domestic and international pressure, and in the face of mass demonstrations, Suharto abruptly resigned on May 21, 1998, after thirty-two years.
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as president. It marked the beginning of the end of the “New Order” regime.

In accordance with the constitution, vice-president B. J. Habibie was sworn in as “interim president” to serve out the remainder of Suharto’s five-year term. Habibie inherited a nation in crisis. Lacking popular support and legitimacy, the new government seemed initially paralyzed. The wanton destruction of property and infrastructure began to take its toll, severely disrupting economic activity. The service sector, including financial and business services, trade, hotels and restaurants, suffered huge losses. Equally savaged was the critical export sector. Indeed, some foreign buyers temporarily stopped placing orders for Indonesian exports. Moreover, both during and in the immediate aftermath of the riots, there were massive runs on all banks, in particular, Bank Central Asia (owned by two of Suharto’s children and his crony Liem Sioe Liong), the nation’s largest private bank, accounting for 12 per cent of the total banking sector liabilities. Bank Indonesia, in conjunction with two of the state banks, supplied over 30 trillion rupiah in cash to Bank Central Asia over the week following May 16 as deposits were withdrawn. Finally, on May 29, Bank Central Asia was brought under the auspices of IBRA, and the owners’ rights were suspended. In this climate of chaos and uncertainty, the rupiah fell to below 12,000 to the dollar by the end of May, and continued to nosedive, reaching Rp. 16,500 against the dollar on June 17 – a cumulative depreciation of 85 per cent since June 1997.

In the face of growing social unrest and international pressure, President Habibie, in a surprise volte-face, accepted the charge that the New Order regime was undemocratic. He now promised rapid implementation of the long-awaited keterbukaan (political openness) and the establishment of Orde Reformasi (Reformation Order). To show his commitment, the Habibie government immediately freed the press from the draconian constraints that had been in force under Suharto, and in a dramatic move dismissed Prabowo (Suharto’s son-in-law) from the Indonesian armed forces (Mietzner 1999, 88–9). Moreover, the Habibie administration revoked the law that limited the number of political parties to two, released political prisoners and voiced support for legal reforms – in particular, the protection of human rights (Anwar 1999, 39–43). Habibie also announced that fresh parliamentary elections (to be preceded by the rewriting of New Order election and political party laws) would be held in June 1999, followed by a significant decentralization of political and economic power away from Jakarta (to be discussed later). In the economic realm, recognizing the severity of the crisis, the government began to take steps to repair the distribution system to ensure adequate supplies of food and other necessities to all parts of the country. Although Habibie’s Minister for Co-operatives, Adi Sasono, espoused the populist Ekonomi Rakyat (or an economy based on government assisted cooperatives), in practice “President Habibie and most of the new cabinet

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showed a greatly increased commitment to implementing the IMF program. Specifically, immediate pressure was off Bank Indonesia to do anything more than restore financial stability. There was significant easing of political pressures to bail out banks, and no apparent pressure on BI to reduce interest rates prematurely again” (Kenward 1999, 124). Moreover, Habibie affirmed that Coordinating Minister for the Economy, Ginandjar Kartasasmita, the official most trusted by the IMF in the last days of Suharto’s presidency, would remain in office – despite a long history of political, policy and personal conflict between Habibie and Ginandjar. Perhaps what pleased the IMF (not to mention a section of the Indonesian business community) most was Habibie’s announcement that the University of Indonesia economics professor Widjojo Nitisastro would have an enhanced advisory role in the government. On June 24, the IMF and the Indonesian government signed the “Second Supplementary Memorandum of Economic and Financial Policies” (IMF 1998d) – a revised version of the economic program signed on April 10, 1998 (IMF 1998c). The new memorandum bleakly noted that “with the disruptions to economic activity and damage to business confidence in recent weeks, it is now expected that real GDP will decline by more than 10 per cent in 1998” (1998d).

Bad as this news was, there was more to come. Compounded by the severe drought brought on by the effects of El Niño, food crop production declined by as much as 8 per cent per capita in 1997–98, resulting in the first large-scale rice imports in over a decade. Overall, the economy contracted by some 13.2 per cent in 1998 (one of the most abrupt one-year slides recorded anywhere in the world in recent economic history), and nominal per capita incomes declined by 65 per cent between 1997 and 1998, from US$1,079 to US$380 (Tan 2000, 118). Literally overnight, hundreds of firms became insolvent and thousands became unemployed. Compounding the problem was inflation. The price of basic commodities such as rice and fuel skyrocketed as inflation jumped to 58.5 per cent. In many parts of Indonesia, the price of rice rose from 800 Rp. per kg to 2,000 Rp. per kg between 1997 and 1998. However, in drought-stricken West Java and East Kalimantan the price of rice rose from 1,000 Rp. per kg in 1998 to more than 5,000 Rp. per kg by the middle of that year. As a result, tens of thousands of Indonesians, many of whom had lived just above the poverty line, were once again reduced to destitution. To deal with the rising social discontent, the Habibie government in consultation with the IMF introduced policies to ease the burden on the poor. Most importantly, in July 1998, the government introduced a special market operations program (OPK), under which BULOG was allowed to sell rice to 7.5 million low-income families at a subsidized price of Rp. 1,000 per kilogram. Each family was entitled to receive ten kilograms of rice per month. In late June 1998, audit results of banks (taken over by IBRA), conducted by international accounting firms during the spring and summer of
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1998, were leaked to the press. The results were devastating. The large extent of delinquent loans, together with the high level of connected lending, illustrated the degree to which the banks had been used as vehicles for directed lending to non-productive ventures. Overall, the level of non-performing loans ranged from 55 per cent to more than 90 per cent of the banks’ portfolios (Enoch 2000, 16). While for most of these banks the loans portfolios were dominated by memo-lending, banks also incurred huge losses as a result of the need to make substantial provisions against problem loans even as earnings capacity was eroded as recording of interest income on non-performing loans changed from an accrual to a cash basis. The huge losses wiped out the capital bases of much of the banking sector, leaving it deeply insolvent. By early August, the results of the portfolio reviews for a group of 16 large banks, all of them non-IBRA (except for Bank Central Asia) became available. The results showed that the financial condition of these banks was also very weak. Given that many of these banks would have been expected to be among the strongest in the country, these reviews confirmed the deep insolvency of the banking system as a whole. The immediate consequence was shock that the state of the banks was so bad; but beyond that, the leak put an end to denial of the seriousness of the banking problems and forced the Indonesian authorities to recognize that the implementation of banking reforms was of the utmost urgency.

Financial sector reforms: achievements and challenges

Some important steps have been taken to improve supervision of the financial sector. Effective May 1999, a new central bank law significantly enhanced the powers and authority of the nation’s central bank, including making it more accountable through requiring periodic presentations by the bank governor to parliament. The new law clearly stipulates that Bank Indonesia has one central objective: to achieve and maintain the stability of the value of the rupiah. To achieve this goal, the law enhanced the Bank’s independence as a state institution outside the administration of the executive branch. This meant that the central bank is no longer to report directly to the president, but to the House of Representatives – and that neither of these institutions have the powers to remove the bank governor or members of the board unless they are found guilty of criminal acts. Despite this, it will take time to improve the supervisory skills at the central bank. That is, although the central bank has developed a “master plan” to enhance supervision, and the IMF has agreed to assist the bank with the implementation of reforms necessary to bring skills on a par with international standards, implementation will take time.

The massive insolvency of the Indonesian banking system called for a major restructuring of the entire sector. In September 1998, with the IMF’s
full support, Bank Indonesia outlined an ambitious multi-billion-dollar bank recapitalization plan, and in October the Indonesian parliament passed amendments to the banking law that modified previous requirements regarding bank secrecy and ended restrictions on foreign ownership of banks.62 These amendments also strengthened the legal powers of IBRA and AMU, enabling them to operate more effectively – for instance, to be able to transfer assets and to foreclose against a non-performing debtor. To show that it was serious about implementing the plans, the government announced (in mid-September), that IBRA would work expeditiously to reduce the total number of small, poorly capitalized banks in the country by promoting bank mergers. True to its word, IBRA carried out the formal merger of 4 large state-owned banks (Bank Dagang Negara, Bank Ekspor-Import (or EXIM Bank), Bank Bumi Daya, and Bapindo) and the corporate business of a fifth state bank (Bank Rakyat Indonesia) into a new institution, Bank Mandiri – which was established on September 30 as the holder of 100 per cent of the shares of the component banks.63 The large capital injection into Bank Mandiri was to make it a financially strong institution capable of being a leading bank in the restructured Indonesian banking system. By the end of 2001, the restructuring program had left the country with 5 state banks and 26 regional development banks, while 160 private banks were consolidated into 85. The restructured state and private banks account for about 90 per cent of the total commercial banking assets of the country.

Moreover, as part of Indonesia’s commitments to the IMF (as expressed in various letters of intent), the government took steps to review and strengthen the prudential and regulatory framework of the banking system. The top priority was to raise the quality of the country’s banking supervision to be move closely in line with international standards. Specifically, three new regulations in the area of loan classification, provisioning and debt-restructuring operations came into effect in late December 1998. In the area of liquidity management, effective early 1999, banks are required to submit a liquidity report twice monthly for their global consolidated operations. Among other things, the report must contain both a foreign-currency liquidity profile and a rupiah and foreign-currency profile. In addition, banks are now required to publish unaudited quarterly financial statements within two months of quarter’s end and audited financial statements within four months of the end of the reporting year (December 31). Also, since the over-concentration of lending to individual debtors or group of debtors was a major problem, the legal lending limit amounts have been significantly tightened.64 No doubt, the frequency and completeness of financial disclosure by banks will greatly assist regulators, as well as the general public, to make a more accurate assessment of a bank’s financial condition and overall performance. In the area of capital adequacy requirements, banks were given until December 31, 2000, to comply with a minimum capital adequacy requirement of 8 per cent. In January 2002, the government began finally to
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crack down – issuing notices to banks that failed to meet the standard that their assets would be transferred to IBRA for resolution if they failed to meet the requirements in the new specified time. Similarly, banks are now required to maintain their net open position in foreign currency at less than 20 per cent of their capital. This is to be reported to the central bank on a weekly basis for the consolidated domestic operations and consolidated domestic and foreign operations. New commercial banks must have a minimum paid-up capital of 3 trillion rupiah, while new rural banks are required to have between 500 million and 2 billion rupiah, depending on where they are located.

The more difficult challenge lies in the area of bank recapitalization. Keeping in mind that non-performing loans are estimated at 60–85 per cent of all loans, and bank recapitalization costs are estimated at a staggering Rp. 643 trillion (about US$89 billion), it will probably take several years to restore the financial sector to health (Lindgren et al. 1999, 65). The recapitalization is being financed by domestic bond issues, pushing up domestic public debt to unprecedented levels. The first significant step towards recapitalization of private banks began in early 1999 – after the government completed (in December 1998), an audit to separate the banks into sound banks, salvageable banks and bad banks. Specifically, the audit carried out by independent auditors of all state banks, nationalized banks, regional banks and private banks, ranked banks into three categories according to their capital adequacy ratio (CAR).

Under the new ranking system, owners of banks in category C (those with a capital adequacy ratio of less than negative 25 per cent) were given an opportunity to inject sufficient equity to push them into a higher category, and thus make them eligible for recapitalization, or face liquidation. In March 1999, the government announced that 38 banks, all deeply insolvent and with no hope of recovering, were to be closed and “their owners will be required to repay their connected [i.e. memo] lending” (Government of Indonesia (GoI) 1999). Indeed, the government announced a list of the 200 largest defaulting borrowers and began the process of actively collecting from the 20 largest defaulters – in recognition of the fact that many owners “generally have substantial outside assets, even after the failure of their banks” (Enoch et al. 2001, 19). Banks with a ratio of negative 25 per cent to less than 4 per cent were assigned the status of Category B. These banks would be eligible to participate in the recapitalization program provided that their owners inject 20 per cent of the new capital required to attain a CAR of 4 per cent. In all, 9 Category B banks were deemed eligible for recapitalization, while 7 category B banks were taken over by IBRA. The seven banks were in serious financial difficulty, although it was stated that, owing to their extensive branch networks, they would be taken over (and not closed) to minimize disruption to the payments system. Former owners of these institutions were blocked from further roles in the management of
banks. The intention was to restructure these banks, improve their financial performance, reduce their burden on the budget and prepare them for privatization. The 74 category A banks (those with a capital adequacy ratio of 4 per cent or higher) were allowed to continue business after being subjected to “fit and proper” tests (GoI 1999).

In view of the fact that Indonesian taxpayers were providing the funds (since there was very little useable collateral in the banks), recapitalization was contingent upon two criteria being met. First, all banks were required to submit business plans that showed their viability over a three-year period, and their managements were required to pass tests ensuring that they were technically competent to run a bank. And second, since many of the banks eligible for recapitalization were owned by some of the country’s major conglomerates, recapitalization required the existing shareholders to provide at least 20 per cent (in cash) of the total funds necessary to restore the bank’s capital adequacy ratio to 4 per cent before IBRA would put in any funds. That is, for every one rupiah of new capital that the owners of the bank injected into the bank, the government agreed to add 4 rupiah – meaning that the government agreed to take on 80 per cent of the cost of bank recapitalization. However, the bank owners have the option of repurchasing the government’s shares within three years, and the right of first refusal to buy the shares for three to five years. In addition, the government agreed to allow these banks to swap some of their non-performing loans for government bonds. Under the plan, banks are allowed to continue to try to collect the bad loans, and if successful may use the proceeds to buy back part of the government’s capital share.

Not surprisingly, since the government provided the recapitalization funds on very generous terms, the proposal has been attractive to many banks. By the end of 2000, the Indonesian banking sector has been significantly consolidated. Since mid-1997, the number of private domestic banks has been nearly halved through closures or state takeovers. By the end of 1999, banks under state control held about 70 per cent of liabilities, compared to 40 per cent before the crisis (Lindgren et al. 1999, 65). In sum, it remains to be seen whether recapitalization will bring some rationality to the banking sector. It should be noted that the recapitalization plan provides little incentive for the banks either to restructure debts owed by corporations or to make new loans. In this regard, Indonesia’s recapitalization plan differs from Thailand’s – which ties some of the government’s capital injections to the amount of corporate debt the bank writes down and the amount of new lending it undertakes.

By mid-1999, the public contribution to financial sector restructuring has been equal to 51 per cent of GDP. The largest share of this has been used to recapitalize banks and provide liquidity support. As was noted earlier, IBRA is financed by a mix of medium- and long-term government-guaranteed bonds, some inflation-indexed, others not. These bonds pay high rates of
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interest, averaging 14 per cent annually. IBRA has exchanged these bonds for the worst non-performing loans in the banking system (the so-called “Category 5” loans). In the process, IBRA has acquired billions of dollars-worth of assets – measured at face value, not market value. First, the question of how best to manage, and ultimately to dispose of these mounting assets remains a major challenge for the regulators. Although the devaluation of the rupiah has made Indonesian assets relatively inexpensive for investors holding strong currencies such as the US dollar, the problems of determining the fair market value of non-performing assets has prevented expeditious sales of assets to foreign investors. Moreover, the potential international market for Indonesian assets has been limited by the fact that foreign fund managers and other institutional investors are generally restricted from purchasing assets that do not have a so-called “investment grade” credit rating from an internationally recognized credit-rating agency. In Indonesia, such assets are far and few between.

Second, although IBRA has been given substantial extrajudicial powers to deal with recalcitrant debtors (it has used threat of criminal prosecution to compel the owners of the suspended and nationalized banks to make the required payments, besides being empowered by the Indonesian government to seize the personal assets of bank owners who fail to make their payments), this has hardly improved IBRA’s performance. An ineffective bankruptcy system and political interference and corruption remain major impediments. For example, the implementation of the program came to an abrupt halt in August 1999 with the outbreak of the Bank Bali scandal. The scandal allegedly implicated senior officials at Bank Indonesia, the Ministry of Finance and IBRA. With the apparent cooperation of these officials, US$80 million was paid by a Habibie-connected company to a private bank (Bank Bali) to recover claims that were in fact already guaranteed by the government, and allegedly to bolster Golkar’s election war-chest for the June 1999 ballot. IBRA’s chairman pointed to aides in Habibie’s Golkar party (and indirectly to the president himself) as behind the scandal. The incident vividly illustrated the fact that, if not corrupt itself, IBRA was unable to prevent abuses. The scandal led to the suspension of the IMF funds in September 1999. In fact, since the Habibie government failed to deal with the scandal, the parliament took on the task of investigating the case. However, when the parliament failed to make any progress, the IMF forced the government to invite an international auditor, Price-Waterhouse-Coopers, to undertake the audit and to make the results public. When the audit was completed, the government refused to publicize the full report. This, in turn, prompted the IMF to postpone the disbursement of funds. The IMF resumed its review and support only after the Habibie government was out of office.

Not surprisingly, the pace of asset disposal and loan recovery by IBRA is quite poor. As of May 2002, IBRA had acquired (at face value) a total of Rp. 360 trillion in non-performing loans (about 21 per cent of GDP in 2001)
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from troubled financial institutions. However, its asset-recovery rate is only about 10 per cent or less, and, by mid-2002, IBRA had disposed of only 12 per cent of its non-performing assets (ADB 2002, 28). At the heart of the problem is the low quality of the assets of many Indonesian banks. This is reflected in the non-performing loan level – which was 15.8 per cent in July 2001, down slightly from the December 2000 rate of 18.8 per cent. In an attempt to speed up asset-disposal, IBRA launched (in June 2002) its largest-ever asset-sale program of bank loan assets worth Rp. 150 trillion (US$17 billion). The sale, which is open for local and international investors, involves 2,500 credit portfolios consisting of restructured and non-restructured loans (ADB 2002, 28). In the light of its burdens, IBRA’s goal of returning all assets under its management to the private sector by its sunset date of February 2004 remains highly optimistic.

Clearly, the level of non-performing loans in the Indonesian banking system is simply unprecedented. Since coming into operation, the AMU has taken over loans from a variety of institutions: closed banks, banks taken over, state-owned banks, and banks participating in the recapitalization schemes. However, not all these loans have been transferred. Moreover, given its limited resources, IBRA has been unable to administer all these loans on its own. In fact, bad loans of less than 5 billion rupiah are handled by the individual banks, bad loans valued at between 5 billion and 35 billion rupiah are subcontracted back to the individual banks (implementation remains under the supervision of the AMU), and bad loans in excess of 25 billion rupiah are handled directly by the AMU. In addition to loans, some non-core assets, including automobiles and office equipment, have been transferred to the AMU. According to the Indonesian government, the total amount of problem debt transferred to the AMU as of January 2000 was approximately 250 trillion rupiah (Root et al. 2000, 192–3).

By year-end 1997 domestic private corporations had borrowed US$53.6 billion from foreign banks, which left the corporate sector (as well as Indonesian banks exposed to these corporates) highly vulnerable to sudden depreciation. By late 1998, of the estimated US$118 billion corporate debt, nearly 60 per cent was owed to foreign creditors and about half the remaining 40 per cent was denominated in foreign currency. This, in effect, rendered the Indonesian corporate sector systematically vulnerable to large-scale depreciation of the rupiah. Indeed, in the early stages of the crisis, the extreme currency volatility and high interest rates saw many debtors stop payments on their debt, while the widespread rupiah depreciation that took place during the height of the crisis drove almost half of Indonesian corporations into insolvency and caused many more corporations difficulties in meeting their debt-servicing obligations. Of course, as Root and his co-authors (2000, 202) note, “this was compounded by the inconclusive steps taken by the Indonesian authorities in the early stages of the crisis to restore confidence in the banking system. Many debtors were simply unwilling to
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negotiate debt payments with institutions that faced possible closure.” It should also be noted that given the ongoing political instability at the time, many debtors were unwilling to enter into negotiations. In this climate, if some hoped that the problem would go away, others used stalling tactics in anticipation of improvements in the exchange rate.

Under IMF’s oversight, the Indonesian government has also taken steps to deal with the massive debt problem. In June 1998, the government reached agreement (the Frankfurt agreement) with a group of private creditors on restructuring three categories of debt. In regard to trade credits, the agreement stipulated that Indonesian commercial banks would repay all trade credits that were in arrears, and in return, foreign banks would maintain trade credits at the April 1998 level. Bank Indonesia agreed to guarantee new trade credits. In regard to inter-bank debt, foreign banks would exchange new loans of maturities of between one and four years for obligations owed by Indonesian commercial banks maturing by March 31, 1999. Again, the new loans are guaranteed by Bank Indonesia. The government’s strategy for corporate debt restructuring has included three elements: first, the establishment of the Indonesian Debt Restructuring Agency (INDRA) to provide foreign-exchange cover for Indonesian corporations with foreign currency-denominated debt once they have reached debt-restructuring agreements. The INDRA plan was voluntary, and under it private sector offshore debt would be restructured so that it could be repaid over an eight-year period, the first three years of which were a grace period during which only interest was payable. The Indonesian government effectively facilitated the debt repayment by offering debtors a subsidized exchange rate so that they could service their loans. In other words, if both parties (the debtors and creditors) agreed, the plan saw debtors paying INDRA in rupiah and INDRA paying creditors in foreign currencies. In this way INDRA is designed to provide protection for the debtors against the risk of further real depreciation of the rupiah, and to give assurance of foreign-exchange availability for debt repayments.67

While the first two initiatives have been relatively successful, INDRA has not been successful, and corporate debt restructuring has been extremely slow. There are several reasons for this. First, even with the exchange-rate guarantee, current exchange rates are simply too unfavorable for most corporations to repay debts. After all, the plan provides little actual cash relief for debtors, since they must still make regular rupiah payments to INDRA. Second, many creditors (especially Japanese banks) have been quite unwilling to write down the value of the loans substantially. It is now recognized that for plans like INDRA to work it is essential to improve implementation of the bankruptcy law. Specifically, voluntary mechanisms for restructuring corporate debt will have greater appeal if creditors have reasonable expectations of being able to enforce their claims against debtors speedily through legal means, should voluntary methods fail.

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The failure of the INDRA plan led the Indonesian government to introduce its second and third initiatives on corporate debt restructuring, the Jakarta Initiative and the Jakarta Initiative Task Force (JITF) in September 1998, to facilitate voluntary negotiations between debtors and creditors for corporate restructuring and to provide a regulatory “one-stop shop” for administrative procedures pertaining to debt resolution. Unlike the earlier Frankfurt Agreement of June 1998 (which dealt entirely with private foreign debt), the Jakarta Initiative introduced a set of principles based on the London Approach to guide voluntary out-of-court corporate restructuring. The JITF was intended to facilitate negotiations between debtors and creditors (particularly, foreign lenders), and to obtain necessary regulatory approvals for deals. As of the end of May 2002, JITF had received a total of 130 registered cases, with a debt value amounting to US$30.3 billion, and completed the mediation of 71 cases, with a debt value of US$15.4 billion. Although debt-restructuring under JITF has been more successful than under IBRA, there are concerns over the quality of debt-restructuring by JITF, as debt-rescheduling still remains the predominant method of restructuring. Also, the initiative has done little to address the fundamental problem of making progress on burden-sharing between the creditors and debtors. In fact, poor enforcement of laws to protect creditors has given debtors little incentive to agree to restructuring deals likely to result in debt-to-equity conversions and substantial dilution of their shareholdings.

Under IMF oversight, in August 2000, the Indonesian government passed the Company Bankruptcy and Debt Restructuring and/or Rehabilitation Act, modeled on US Chapter 11, to facilitate reorganization of illiquid, but financially viable companies. The new bankruptcy system also introduced a special commercial court (to deal with the administration of the bankruptcy law) in order to provide a credible threat. The new bankruptcy law ensures that all creditors have equal rights to the assets recovered as the result of a bankruptcy proceeding. Moreover, it seeks to give creditors increased power to force debtors to restructure and pay off their debts, including giving creditors greater ability to liquidate the assets of the debtor in the event the debtor refuses to pay. The effectiveness of the bankruptcy law remains to be seen.

Democracy and reforms

On June 7, 1999 Indonesia held a democratic election for the first time since 1955. Forty-eight political parties competed, with 21 winning at least one of the 462 contested seats in the 500-member national Dewan Perwakilan Rakyat or parliament (the additional 38 seats are made up of appointed armed forces delegates). Simultaneous elections were held for legislatures in 26 provinces and more than 300 districts and municipalities. Over 90 per cent
of registered voters turned out for the three-level elections.69 At the national level, the PDI-P (Partai Demokrasi Indonesia-Perjuangan), a secular nationalist party, received the highest share of the popular votes winning 34 per cent of the vote and 153 seats in parliament, Golkar (Golongan Karya) won 22 per cent, of the vote and 120 seats, the PKB (Partai Kebangkitan Bangsa) won 12 per cent of the votes and 51 seats, PPP (Partai Persatuan Pembangunan) won 10 per cent of the votes and 58 seats and PAN (Partai Amanat Nasional) won 7 per cent of the votes and 34 seats.70 On October 20, 1999, the 700-member Majelis Permusyawaratan Rakyat (People’s Consultative Assembly) met to elect a new president and vice-president to govern the world’s fourth most populous nation for the next five years.71 Given that Habibie’s Golkar party performed poorly in the election, not to mention that he was badly tainted by the Bank Bali scandal, Habibie resigned his candidacy for president before the October 20 vote. This left the assembly to choose between the enigmatic Abdurrahman Wahid, the leader of Indonesia’s largest Islamic group (the 40-million strong Nahdlatul Ulama), and Megawati Sukarnoputri, daughter of Indonesia’s first president. Despite her party’s having gained a higher share of the popular vote in June than any other group, Megawati lost the contest for the presidency. The Muslim parties and Golkar cooperated to elect the long-time democratic activist and PKB leader, Abdurrahman Wahid (also fondly known as Gus Dur), as president. Wahid received 373 votes, as against PDI-P’s Megawati Sukarnoputri with 313. Megawati’s supporters mounted large protests in Jakarta and elsewhere in Indonesia, and on October 21 Megawati was elected with an overwhelming majority as vice-president. She was constitutionally poised to succeed the sickly Gus Dur (who had already suffered two strokes) if he did not finish his five-year term.

The Wahid government inherited an economy that was slowly on the mend. Indeed, as Emil Salim (2001, 211) notes, “the Habibie administration made substantial gains in economics.” In 1999 the rate of economic growth was 2 per cent, and in 2000 around 4 per cent – signaling that the worst of the contraction may be over. Similarly, inflation, which stood at 77 per cent in 1998, dropped to around 2 per cent by December 1999, and the new floating exchange rate seems to be functioning well, stabilizing at around Rp. 7,000–7,500 to the US dollar. However, Indonesia has not experienced the “V-shaped recovery” evident in the other Asian crisis economies. In spite of the sharp real depreciation of the rupiah and the recovery of oil prices, export performance has been disappointing. It seems that foreign investors and the Sino-Indonesian business community are still holding back, pending clear signals regarding political stability and security.

After his first 100 days, President Wahid began 2000 amidst popular goodwill. He committed his government to the rapid implementation of the economic reform measures, and immediately after the October elections signed a new letter of intent with the IMF. However, policy-making and
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implementation in a deeply fragmented parliament with its competing parties and factions has not been easy. Moreover, President Wahid’s well-intentioned decision to form a “national unity cabinet” created its own problems. In the economic arena, it was reflected in the fragmentation of economic decision-making authority within the cabinet between a number of competing ministers and their outside advisors. This delayed the implementation of reforms, in particular, corporate debt restructuring – culminating in the embarrassing suspension of US$400 million in IMF support in late March 2000.72 However, the IMF action seemed to act as a wake-up call, as since then the Wahid administration has made concerted efforts to implement economic reforms, including addressing the problem of corruption and the Suharto family wealth.

To compensate for the problems associated with the Bank Bali scandal and to renew its commitment to reforms, the Wahid government gave IBRA extraordinary powers (the so-called PP17 powers) effective from October 1999 to seize the assets of uncooperative debtors. IBRA used its PP17 powers for the first time in December 1999, seizing two properties, including fourteen hectares of land in Jakarta from a firm owned by a Suharto family member. Similarly, in an effort to energize the JITF, the government has approved time-limited procedures for JITF mediation of its cases and agreed that the JITF may refer cases of uncooperative debtors to the government’s Financial Sector Policy Committee for action by the attorney general’s office in the Bankruptcy Court. Also, the government has made concerted efforts to address the negative perceptions about governance in judicial processes. There is a realization that delays in corporate debt restructuring will impede economic recovery. Likewise, while Indonesia undoubtedly faces daunting challenges to reforming its banking and financial sector, the realization that a weak banking sector made Indonesia particularly vulnerable, and deepened the depth and duration of the crisis, is a strong incentive to move forward with the reforms.

For some five decades, Indonesia has been a multi-tiered unitary state, with provinces as the second tier below the center, and the local (district) governments as the third tier, with the village serving as the fourth tier. The centralization of authority in Jakarta was long justified as a way of maintaining national unity in a multi-ethnic society, spread across some 14,000 islands and 2 million square kilometers. With the collapse of the Suharto regime, power quickly began to shift away from the center to the provinces and districts. Cognizant of this reality, the Habibie government passed in May 1999 two laws (which came into effect on January 1, 2000), designed to change intergovernmental political and fiscal relations in Indonesia dramatically. The two laws – Law No. 22/1999 on Regional Government (UU PD) and Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions (UU PKPD) – significantly devolved power to the local districts, rather than to provincial governments. First,
Law No. 22/1999 eliminates the hierarchical relationship between the provincial and the district governments. The district governments, both the *kota* (municipality) and *kabupaten* (district), are now fully autonomous, and need no longer report to the governor of the province. Instead, the district heads will be responsible to the locally elected assembly, the Dewan Perwakilan Rakyat Daerah. In contrast, the provinces will retain a hierarchical relationship with the central government. Second, Law No. 25/1999 fundamentally alters the transfers received by local governments from the central government. Most importantly, the law introduces revenue-sharing for provincial and district governments, assigning each level of government its share of revenues from taxes on land and buildings, forestry, mining, fisheries, oil and gas. Of course, this means that provinces rich in oil and natural gas, such as Riau and East Kalimantan, have the potential to benefit. While it is hoped that such unprecedented decentralization will empower local communities, make government more accountable (and thereby reduce corruption), and promote more sustainable and equitable patterns of economic development, only time will tell if devolution fulfills its ostensible goals.

By mid-2000, President Abdurrahman Wahid had squandered his political capital. In August 2000 he was censured by parliament, and only survived in office by apologizing. In February 2001 he once again received a parliamentary censure – which was supported by 86 per cent of legislators in the House of Representatives (DPR). Supposedly at issue was his implication in two financial scandals and his alleged refusal to acknowledge the DPR as his constitutional equal. Tainted with corruption and politically isolated, Wahid functioned as a lame-duck president until his removal from office by the MPR on July 23, 2001. The performance of Wahid’s successor, Megawati Sukarnoputri, has been much better. In sharp contrast to Wahid, the Megawati administration improved relations with the IMF and introduced modest reform measures. Nevertheless, corruption remains rife, the implementation of economic reforms haphazard, and the ill-planned implementation of decentralization laws continues to erode central authority. Clearly, the legacy of the 1997–98 economic crisis is so devastating that successive governments will continue to grapple with Indonesia’s formidable economic problems.

Notes
1 Furman and Stiglitz (1998) find that Indonesia’s crisis was the least predictable within a sample of 34 troubled countries.
2 Quoted in Higgins (1968, 678).
3 Critics have argued that the official Indonesian data on the poverty line – the average consumption by household members below which a given household is
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classified as poor – were originally set too low, resulting in a low estimate of the incidence of poverty and possibly an overestimation of the reduction in poverty over time. While Indonesia’s poverty line has indeed been rather low compared to those of other Asian countries, “all things considered, and whatever its exact dimensions, a prolonged and broad-based improvement in living standards under the New Order did take place” (Booth 1999, 129).

4 Hollinger (1996, 20) writes that “in the early years of the Soeharto administration a new foundation for fiscal policy was put into place: the so-called ‘balanced budget principle’ which was enacted into law. This still remains today as the guiding rule on the budget and is embodied in each year’s annual budget law as passed by parliament. ‘Balanced’ has a specific meaning in the Indonesian policy context. The requirement is that the total of government expenditures, including both the ‘routine’ expenditures and the ‘development’ expenditures into which the Indonesian budget is divided, cannot exceed the total of tax revenues collected domestically plus official foreign aid.”

5 As was noted earlier, the steep appreciation of the currencies of Japan, South Korea and Taiwan after 1985 led producers of exports in these countries to relocate their labor-intensive manufacturing processes to other parts of Asia where wage costs were lower. Indonesia, along with Thailand and Malaysia, benefited from the resulting flow of foreign investment from East Asia – much of it in export manufacturing.

6 After hitting a historic high of 80 yen to the dollar in June 1995, the yen experienced a downward trend, falling to 127 yen to the dollar in April 1997 – or just before the Asian crisis broke. The yen’s sharp depreciation led to a marked deterioration in East and Southeast Asia’s export performance and current-account imbalances in 1996, paving the way for the currency crisis.

7 Jabotabek, or the greater Jakarta metropolitan region, comprising Jakarta–Bogor–Tangerang–Bekasi.

8 Other measures included (a) the removal of credit ceilings for all banks, and (b) the elimination of taxes on interest, dividends and royalties on foreign-currency deposits in all state banks (Prawiro 1998, 226–7).

9 The 1983 reforms were enacted at a time when Indonesia’s earnings from oil (its principal export commodity) were declining. In the two-year period 1982–83, Indonesia’s export earnings from oil fell by 24 per cent. The Indonesian government recognized that a more efficient and well-developed banking system would help foster the creation of a more diversified national economy. For details, see Bennett (1995).

10 See Lindgren et al. (1999, 13).

11 For example, Suharto’s eldest daughter, Siti Hardiyanti Rukmana, held interests in telecommunications, agribusiness, toll road construction and shipbuilding. The president’s son, Bambang Trihatmojo, controlled the large Bimantara group, which was active in telecommunications, real estate, agribusiness, food retailing, construction and electronics. In fact the Bimantara Group was granted special concessions for overseas distribution of the state petroleum company’s products, and high tariffs to protect a US$2.2 billion plastics plant built jointly with German and Japanese multinationals. Suharto’s youngest son, Tommy, had similar interests, including petrochemicals and automobiles. Likewise, Suharto’s other children, Sigit Harjoyudanto, Siti Hediati, Siti Hutami Endang Adiningisih,
and his grandson, Ari Harjo Wibowo, and Suharto’s half-brother, Probosutejo, controlled large business conglomerates. It is not known exactly how far Suharto’s own business interests extended. He and his wife, Tien (before her death in April 1996), controlled several non-profit foundations or yayasan, which were not required to disclose their economic holdings and activities. For details, see Eklof (1999).

12 Hale (2001, 632) notes that, “for example, a similar type of car such as the Toyota Corolla would be subjected to an import duty of 50%, a luxury tax of 35%, an import surcharge of 2.5%, and a value-added tax of 10%. The Timor car, on the other hand, was exempt from all but the 10% value-added tax. The Corolla thus sold for around 70 million rupiah, or $30,000 at pre-crisis exchange rates, whereas the Timor sold for about half that price. In fact, at a market price of 35.75 million rupiah the Timor was considerably cheaper than other similar import models such as those from Opel (GM) and Peugeot as well.”

13 Bank Indonesia’s Monetary Management Director, Dr C. Harinowo, explained that “the benefit [of widening the rupiah band] is providing us more autonomy to managing monetary policy. We do not need to be concerned with the exchange rate, which affects monetary aggregates. It gives us a bigger cushion if there are any speculative attacks. It provides us with an experience of a floating-rate regime, but within a narrow confinement” (Henderson 1998, 127).

14 Soesastro and Basri (1998, 7) note that between 20 July and 13 August Bank Indonesia’s interventions in the market had depleted the reserves by over US$1.5 billion.

15 This measure, of course, reduced the costs incurred by banks borrowing in the interbank market.

16 The finance minister Mar’ie Muhammad made it clear that the government was only seeking the IMF’s technical assistance, and would explore the possibility of financial support only as a precaution. Indeed, on October 8, the IMF was invited for consultation only, and no explicit request for a loan was made (Soesastro and Basri 1998, 10; also Hill 1999, 15).

17 While the technical details of the bilateral assistance were worked out between Indonesia and the individual countries, the United States made it clear that its loans could only be drawn upon if Indonesia followed the agreement with the IMF. It should also be noted that US$5 billion out of the total IMF package included Indonesia’s own assets.

18 The “letter of intent” released by the Indonesian government on October 31, 1997 described the policies that Indonesia intended to implement in the context of its request for financial support from the IMF. For details, see (IMF 1997e).

19 Borsuk (1999, 149) notes that “the blatant dispensation given by Suharto to his son made a farce of the ‘national car’ policy and strengthened the case being made in Tokyo and elsewhere that it broke WTO rules.” In March 1998, the WTO verdict argued that the Timor’s tax advantages violated international trade rules.

20 According to the finance minister Mar’ie Muhammad, the banks were “insolvent to the point of endangering business continuity and disturbing the whole banking system” (Eklof 1999, 107). The liquidated banks were: Bank Harapan Sentosa; Sejahtera Bank Umum; Bank Andromeda; Bank Pacific; Bank Guna Internasional; Bank Astria Raya; Bank Dwipa Semesta; Bank Jakarta; Bank Industri; Bank Citrahasta Dhanamanunggal; South East Asia Bank; Bank
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Mataram Dhanarta; Bank Pinaesaan; Bank Anrico; Bank Umum Majapahit Jaya; and Bank Kosagraha Semesta.

21 On the other hand, as Blustein (2001, 106) notes, “many foreign analysts praised the bank closures in particular as a sign that Indonesia was being forced to change its ways.”

22 Likewise, Djiwandono (1999a, 148) notes that “the domestic reaction to the closure of the banks was the reverse of what was expected. It was ironic that a step designed to restore confidence to the banking sector resulted in the collapse of confidence and plunged the banking sector into chaos.”

23 Indeed, the IMF saw the forced liquidation of the 16 banks as a sufficiently important step towards reforming the banking system. Thus, on November 5, 1997, the Fund approved the three-year Stand-By Arrangement (totaling US$10 billion) – and released the first installment of the promised aid package.

24 In all fairness it should be mentioned that a blanket deposit guarantee was not introduced because of the moral hazard effect. It was believed that the 16 banks being closed were very small, and hence, that there was no need for such a guarantee.

25 Eklof (1999, 108) writes that “Bambang filed a lawsuit against Mar’ie Muham-mad, claiming that the minister had closed the banks in order to discredit his family and, indirectly, to topple his father.”

26 Eisuke Sakakibara, the Japanese vice-finance minister, gives a first-hand account of his dealings with Suharto. He states, “He [Suharto] flatly stated that he would agree with the IMF plan, but had no intention of observing the conditions. . . . The president, his family and cronies began to realize that the structural reform plan initiated by the IMF and technocrats might shake the foundations of the Suharto administration” (DeRosa 2001, 102).

27 While no authoritative figures existed on the size of the debt, it was widely believed to be substantial. Estimates ranges from US$35 to US$70 billion – much higher than Indonesia’s official foreign reserves.

28 Blustein (2001, 99–100) observes, “nobody – not Bank Indonesia, not the IMF, not the World Bank – seemed to have the faintest idea about what had suddenly become a hugely troubling question: How many dollars would Corporate Indonesia have to obtain in the next few months to pay its foreign creditors what it had borrowed?” Equally troubling was the realization that “the demand for US$ to cover unhedged borrowings has been far greater than first thought by Bank Indonesia, or by private sector analysts.”

29 Moreover, these credits added substantially to the money supply and helped to fuel inflation in early 1998.

30 The budget would take effect from April 1, 1998.

31 Why did Suharto choose to defy the IMF? There seem to be two considerations. There was concern, first, that a contractionary budget would force many Indonesian companies, including those owned by his family members and cronies, into bankruptcy, and second, that the elimination of food and fuel subsidies would ignite civil disorder.

32 A report in the Washington Post (January 8, 1998), mentioned that both the IMF and the United States Treasury were unhappy with Suharto’s budget, and questioned his commitment to implementing the agreed IMF program (Radelet 1999, 11).
According to Azis (1999, 85), “pandemonium set in when on 8 and 9 January, people went on a buying spree to hoard foodstuffs.”

The ethnic Chinese have long been easy targets. While they make up 3 per cent to 4 per cent of the population, they are rumored to control 70 per cent to 80 per cent of the economy (Azis 1999). However, others have questioned this figure, arguing that the Indonesian Chinese control far less (Wanandi 1999). For details on how Suharto and his son-in-law tried to promote the anti-Chinese campaign, see Mietzner (1999) and Eklof (1999).

Peregrine made its loan to Steady Safe as part of a deal whereby Peregrine was the underwriter for the bonds that Steady Safe was issuing to refinance its short-term debt and a US$118 million loan from Hong Kong Bank. Peregrine was to square its position once the bonds were sold. Unfortunately for Peregrine, investor interest in bonds evaporated when the financial crisis broke, and it was unable to square its position. A debt-equity swap was not feasible because the crisis in the Indonesian economy following the massive depreciation of the rupiah had drastically reduced the market value of Steady Safe to only US$4.7 million (Sender and Granitsas 1998). It is useful to note that, prior to the outbreak of the crisis, Steady Safe had used US$145 million to buy 14 per cent of a toll-road building company owned by Suharto’s eldest daughter, Tutut. She was then named to the Steady Safe board. Yet the main earnings of Steady Safe came from its Jakarta taxi franchise. Steady Safe had no dollar revenues, and its annual income was equivalent to only US$9 million. Its high price-earnings ratio before the crisis was due to the as yet unrealized promises of the toll-road company, which were contingent on its close relationship with Suharto’s daughter.

Much was made of this event by the media. As Bresnan (1999, 93) notes, “as Suharto affixed his signature, IMF managing director Michel Camdessus stood over him, arms folded across his chest, looking every inch the school-master he was playing in the drama. The photograph of this scene became a symbol of the charged issue at the heart of the negotiations – whether the IMF, and through it the United States, had the right to dictate terms to the Indonesian government in return for help in restoring confidence in its economy.”

SBIs, or “Sertifikat Bank Indonesia” are issued every Wednesday with a one-month duration, but from October 1998 Bank Indonesia also began to issue three-month SBIs.


Similarly, Enoch et al. (2001, 13) note that “there was evidence that the [Indonesian] authorities had limited commitment to the program they had agreed with the IMF, and had made numerous policy reversals.”

It was well known that Habibie, who had major financial stake in almost every business activity in Indonesia, epitomized the unscrupulous crony capitalism and the perverse business subculture. Habibie’s government-funded aircraft project was among those targeted by the Fund. It was no secret that the IMF and the United States did not want him to be vice-president. For details, see Bresnan 1999, 92–4.

Of course, several months later the IMF recognized this fatal mistake and eased up on its fiscal targets in Indonesia (as it did in Korea and Thailand); but the damage had been done.
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42 Blustein (2001, 216) observes, “the obvious question is why the IMF sidestepped the matter in the January 15 program. Part of the answer is that the Fund, for all its expertise in macroeconomic policy, has few specialists in corporate finance.”

43 The guarantee was due to expire on January 31, 2000. At that time it would be replaced by a deposit insurance scheme. The guarantee was retroactively applied to the 16 closed banks. The guarantee initially excluded debts of bank owners, connected lending and subordinated debts. However, under enormous pressure from large depositors in the banks that had been closed in November 1997 (which included a number of powerful foundations), the finance minister announced in February 1998 that the guarantee would also be applied retrospectively to those banks.

44 Prior to the creation of IBRA, Bank Indonesia was the primary supervisory body for the banking industry. IBRA is known in Bahasa Indonesia as Badan Penyehatan Perbankan Nasional (BPPN). IBRA initially operated out of the premises lent by the central bank. Later in 1998, it took over the headquarters of a bank it had closed. Most IBRA staff initially were seconded and paid by their seconding institutions.


46 Kenward (1999, 122) notes that “by mid-April [1998], all senior management at the central bank had been changed. Among the new Managing Directors, barely half had experience in a central bank.”

47 For details regarding Suharto’s remarks, see The Singapore Straits Times, March 9, 1998.

48 In mid-February 1998, a leaked letter from the IMF’s managing director threatened the withdrawal of financial support if a currency board was established (C. Johnson 1998, 27–8). However, Blustein (2001, 225) explicitly notes that “on February 11, Camdessus sent Suharto a private letter warning him against proceeding with Hanke’s plan. The second $3 billion tranche of the Fund’s $10 billion, three-year loan for Indonesia was scheduled for consideration by the Executive Board in mid-March, and Camdessus’s letter left little doubt that a currency board would cause the Fund to cut off money to Jakarta.”

49 DeRosa (2001, 104) notes “the rupiah was trading well above 10,000 at the time. Market participants and pundits quickly concluded that the Suharto family was planning to loot the central bank’s reserves by converting rupiahs for dollars at a massively preferential rate of exchange, meaning that they would have first dibs on the central bank’s dwindling foreign reserves.”

50 The name “New Order” was originally meant to distinguish the Suharto regime from its immediate predecessor, the “Old Order” of President Sukarno.

51 On August 18, 1945, the Republic of Indonesia promulgated its first constitution. According to this charter, in effect from 1945 through to 1949 and reinstated in 1959, the People’s Consultative Assembly (PCA) or the Majelis Permusyawaratan Rakyat (MPR) is the country’s highest governing body. The MPR met quinquennially, within a few months after a parliamentary election, to elect the president and vice-president and establish the broad outlines of state policy for the next five-year term. The president holds a mandate from the assembly to carry out the program. Below the assembly is the parliament or DPR (Dewan Perwakilan Rakyat), which meets annually. Parliament is responsible for
legislation and must approve the budget submitted to it each year by the government. The number of seats in the assembly was set at twice that of parliament. In 1997, the DPR consisted of 500 members – 400 of these were elected and the remaining 100 were military appointees. The so-called super-parliament, the People’s Consultative Assembly, consisted of all members of the DPR, plus an additional 500 appointees appointed by Suharto. Thus, in practice, Suharto controlled the appointment of 60 per cent of the delegates in the assembly which elected him. Every fifth year between 1973 and 1998, the MPR unanimously re-elected Suharto to the presidency. Similarly, official control of the party system was pervasive. Only three entities were permitted to contest elections: the state party called Functional Groups (Golongan Karya or Golkar), the Development Unity Party (Partai Persatuan Pembangunan or PPP), and the Indonesian Democracy Party (Partai Demokrasi Indonesia or PDI).

52 Bawazier was also a strong proponent of the currency-board system.
53 For details, see Blustein 2001, 230–3.
54 The fuel price increase (although not its precise timing) was one of the IMF conditions. Although the IMF defended the Indonesian government’s decision to raise the prices, it is not clear if the IMF wanted the measure to be implemented incrementally or all at once, albeit the April agreement allowed for the gradual phasing out of the subsidies. In any case, the Suharto government imprudently implemented the measure all at once – with severe consequences for the vast majority of Indonesians.

55 Newspaper reports quote Syarwan as regularly referring to Chinese-Indonesians as “rats.” Eklof (1999, 136) notes that “Lieutenant-General Syarwan Hamid, spoke about the need to eradicate rats in Indonesia’s economy, saying: these rats took away the fruits of our national development and work for their own self interest. Don’t think that the people do not know who these rats are. It’s time to eliminate these rats.” For details on how Suharto and his cronies targeted the Indonesian-Chinese community, see Eklof (1999, 134–43).
56 Leo Suryadinata (2001, 506) notes that “starting on May 13, Jakarta saw two days of large-scale unrest directed against the city’s ethnic Chinese population. Their shops were ransacked, looted, and burned down; many were attacked; and numerous ethnic Chinese women were tortured, raped and killed.”
57 Anwar (1999, 34) notes that Suharto’s “abrupt decision came about because he could not find anyone to join his new reform cabinet.”
58 It should be noted that some argued that since Suharto and Habibie were elected together as president and vice-president, both should resign. The question of legitimacy thus dogged Habibie’s presidency. For details, see Anwar 1999.
59 Professor Widjojo Nitisastro is considered the chief architect of the New Order development policy. He served as Suharto’s chief economic advisor from the mid-1960s to the early 1980s. In later years he was frequently called upon to rescue the economy from the depredations inflicted on it by Suharto’s children, and by big spenders such as Habibie and Ginandjar. Widjojo’s commitment to market-oriented macroeconomic policies reassured both the IMF and sections of the Indonesian business community.
60 For details on the various estimates of poverty, see Booth 1999a.
61 While the program did provide immediate relief to many of the hardest hit, it had little impact on the large number of urban poor who have no official
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resident status. In October 1998, the government announced that the OPK program would be extended to 17 million families, with each family entitled to receive 20 kilograms of rice per month. In addition, a supplementary food program for children and expectant and lactating mothers was initiated in late October 1998.

62 Under the recapitalization plan, for every rupiah of fresh capital injected into banks that qualified for recapitalization, the government would put up Rp. 4. In return for its injections of capital (which were to be refunded by bond issue) the government would receive equity stakes in the banks. Bank owners would then have three years to redeem part of or the entire government stake.

63 Following the legal merger in July 1999, the government began plans to privatize Bank Mandiri and the three remaining state-owned banks.

64 The legal lending limit for an individual non-connected debtor or group of debtors is 30 per cent of capital until December 31, 2001; 25 per cent of capital during the year 2002; and 20 per cent of capital as of January 1, 2003. The legal lending limit for connected parties (both individual debtors and groups of debtors) may not exceed 10 per cent of capital, and the legal lending limit for the total of connected parties may not exceed 10 per cent of capital (Root et al. 2000, 197).

65 The recapitalization scheme involves an exchange of government bonds for outstanding shares between the government and the recapitalized bank – and thus requires no cash up-front. The only initial cost is fiscal, with the interest cost of bonds estimated at Rp. 38 trillion in the FY 1999/2000 budget. The fiscal costs are to be financed by the proceeds of privatization and assets of IBRA. These assets include non-performing loans and capital assets transferred to IBRA by the banking system.

66 According to Hufbauer (1999), as of August 1999 IBRA had acquired some Rp. 500 trillion (US$85 billion) of assets, measured at face value, not market value. According to an IMF study (see Enoch et al. 2001, 39), by late 1999 IBRA had assumed responsibility for assets with a face value of 441 trillion rupiah (36 per cent of GDP). It had 174,878 debtors, out of whom those owing over Rp. 50 billion represented 68 per cent of the value of the debt, but less than 1 per cent of the total number of debtors.

67 However, INDRA does not provide commercial risk protection if debtors do not make payments in rupiah.

68 The London Approach, formulated by the Bank of England in the 1970s and developed further in the 1990s, consists of a set of non-binding principles to guide debt-restructuring processes. It has three objectives: to minimize losses to creditors and other parties; to avoid unnecessary liquidations of fundamentally viable debtors; and to ensure continued financial support to viable debtors.

69 Liddle (2000). East Timor at that time was still the 27th province, but did not participate in the elections.

70 Two other parties with significant support were PBB (Partai Bulan Bintang) and PK (Partai Keadilan), which won 2 per cent and 13 seats and 1 per cent and 6 seats, respectively (Liddle 2000, 33).

71 The 500-member DPR plus 200 appointed representatives from various social groups and Indonesia’s 27 provinces (five delegates for each of the 27 provinces, giving a total of 135) constitute the 700-member MPR – which selects the
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country’s president and vice-president, sets out guidelines for administration policy, and is responsible for holding the administration accountable for its activities at the end of every presidential term. With the departure of East Timor, the number of regional representatives dropped by five, for a final total Assembly membership of 695.

72 The IMF delayed its disbursement because it found that Indonesia had made almost no progress on the promises it made in January 2000.