Part II: Country Analysis - Chapter V The IMF Program in Indonesia

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Chapter V

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Introduction

Mihira's article "Indonesia: Paying for Massive Foreign Debt," in *The 1997 Asian Currency Crisis in Nine East Asian Countries: Analyzing Factors and Influences of the Crisis in the Region* (the Institute of Developing Economies, 1997) has already provided a detailed account of factors in the currency crisis in Indonesia from July 1997, when Thailand effectively released the baht from being pegged to the U.S. dollar, to November 3, when the IMF's first program began. This report takes up where Mihira's article left off and analyzes the Indonesian economy after November 1997, with particular emphasis on fluctuations in the exchange rate between the rupiah and the dollar and the role of the IMF. In order to analyse the various historical events over approximately one year, we will use three basic conceptual frameworks.

One is the opposition and rivalry between the technocrats (also called "economists") and the technologists (also called "nationalists" or "politicians"), a fundamental feature of the policy formation process in Indonesia[1]. Former President Soeharto (hereafter referred to simply as "Soeharto") had specific uses for each group, depending on economic conditions, in order to handle the two-pronged task of economic development, namely, modernization and industrialization of the economic system at the same time. However, structural reform based on the advice of the technocrats advanced the most when the economy was facing difficult circumstances due to external shocks such as the fall in oil prices. The tendency to let the technologists manage the economy when it was running smoothly and to make policy decisions that often violated economic principles, but to follow the guidance of the technocrats and emphasize market principles and promote structural reform when the economy was in trouble, is sometimes referred to as "Sadli's Law," after Professor Sadli of University of Indonesia, who first pointed out this phenomenon[2].

The second framework is the uncovered interest parity condition for determining the current exchange rate. According to this theory, if the difference between domestic and foreign interest rates and a risk premium (or discount) for holding foreign currency assets are given, the ratio between the current exchange rate and the expected exchange rate in the future (several minutes later, several hours later, the next day, several days later, several weeks later, and so on) is determined uniquely. Therefore, if for some reason the expected exchange rate doubles, the current exchange rate also doubles, and when the former decreases by half, the latter also decreases by half. The exchange rate at each point in time depends on the exchange rate at the next point in time. A sort of self-fulfilling prophecy prevails in the exchange markets in the sense that the current exchange rate moves with the expected exchange rate. This characteristic of the exchange rate means that its value may easily turn into bubble, under some circumstances.

The third framework is a dynamic game framework, in which government and the market determine their current actions respectively, based on predictions about each other's future actions. This framework allows us to link the self-fulfilling nature of the exchange rate and the dynamism of policy decision making processes. In this framework, predictability of government policies is an essential condition for both exchange rate stability and the stability of the macro economy. If the government's policies are not clear, most companies and investors cannot devise reasonable investment strategies, and they withdraw from the market. The only players who remain in the market are the investors who thrive on danger and dare to take risks and the companies and individuals which absolutely require foreign currency. When that happens, the government also becomes unable to make policies predicated on reasonable actions by companies and investors. The market turns into a mere casino, and the exchange rate loses its fundamental linkage with the economy and turns into a bubble. When the predictability of government policies is lost, along with the stability of the policy formation structure that supports it, the foreign exchange market stop functioning, for all practical purposes. As we shall see later on, this is exactly what happened, when the rupiah-dollar exchange rate fell from 6,000 rupiah per US dollar to 16,000 rupiah in January 1998.

1. The Technocrat's IMF Program without the IMF: Before October 8

The government of Indonesia asked the IMF for financial assistance on October 8, 1997. If we take a bird's eye view of the entire Indonesian crisis over the course of the past year, this was a decisive turning point which defined the essential characteristics of the crisis. Even so, on October 8, when the government requested IMF assistance, it considered its action as the continuation of its policies and it did not realize that this move would fundamentally change the nature of the crisis. It was only in January 1998, that it became clear that an important discontinuity had been introduced into the policy decision mechanism. In order to avoid overlap with Mihira's article, we will take a brief look at the situation leading up to the decision of October 8 and consider how and why it arrived at that decision.

When the Thai baht (July 2), the Philippine peso (July 11), and the Malaysian ringgit (July 14) floated their currencies in quick succession, Indonesia absorbed downward pressure on the rupiah just by expanding its range of fluctuation against the dollar from 8 percent to 12 percent on July 11. But as speculative pressures increased, it was forced to follow the peso and ringgit, switching to a floating exchange system one month later on August 14.

The fact that Indonesia floated its currency later than other countries was not due to intervention by the Indonesian central bank[3] but due to the relative weakness of speculative market forces. One reason is the widespread belief that Indonesia's macro fundamentals were good. Another reason is that the range of fluctuation of the rupiah-dollar rate was at its lower limits (i.e., the rupiah was appreciating), expanding from 3 percent in January 1996, to 5 percent in June and 8 percent in September 1996, so it was difficult for speculators to target the rupiah. Yet with the other major currencies floating, it was impossible for the rupiah to maintain an intervention band by itself, and as pressure to buy dollars rose after August 12, the government switched to a floating system on August 14.

At the same time that it floated the rupiah, the central bank also raised the domestic interest rate nearly 100 percent and took measures to control speculative flows of capital. In addition, as Mihira describes in detail, the government tightened its fiscal policy, including cancellation or postponement of major projects, and other structural reforms. The policy makers brimmed with confidence as they responded to the currency crisis, an attitude supported by their experience of riding out currency speculation in 1991 with a similar set of policies.

Even so, beginning some time after September 26, the situation in the foreign exchange markets changed, and the flow of dollars into the market suddenly thinned. For that reason, the rate of the rupiah against the dollar, which had held steady at around 3000 rupiah, suddenly began to rise, as shown in Fig. 1, exceeding 3500 rupiah on October 3 and passing 3700 rupiah on October 6. Newspapers reported at that time about the state of the market as follows:

> "Traders said Indonesian companies were urgently looking for dollars in a thin market to pay off foreign debt, as the currency started sliding. . . . 'It was horrific,' one Western trader said. 'Suddenly everybody is pessimistic. We were like a flock of sheep.' "(*Financial Times*, October 6, 1997)
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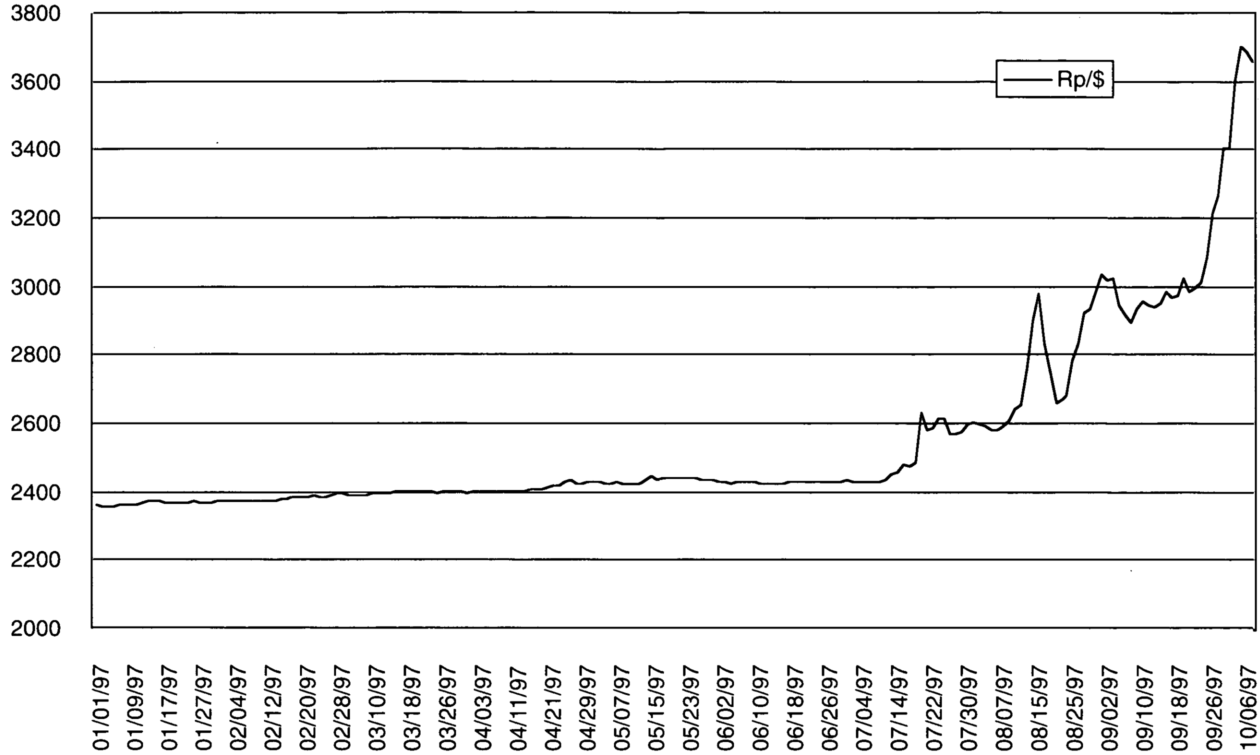
> "The markets are waiting for the Indonesian government to take new measures to halt the slide of the rupiah. Yesterday, when President Suharto met with his economic advisors, some analysts were expecting announcements of new policies. . . . The Indonesian nightmare is a private foreign debt that is seen as amounting to at least 60 billion dollars. One-third of that is short-term debt, and it is believed that almost none of that is hedged. . . . The depreciation of the rupiah has increased the debt burden, and that is creating an increasing demand for dollars." (*The Guardian*, London, October 7, 1997)

What we can read from these reports is the fact that the markets were beginning to recognize that large numbers of private companies were obligated to pay huge amounts of foreign debt and that this perception caused the market sentiment to shift suddenly to a pessimistic outlook. Fuelled by this common recognition of the private foreign debt repayment burden, the depreciation of the rupiah created anxiety about further depreciation, and this accelerated the depreciation process even more, giving the appearance of a self-fulfilling process.

Fig. 1 Rp/$ (97/01/01-97/10/08)



The private foreign debt repayment burden was a new element that had not existed in the 1991 currency crisis. Yet the problem of increased foreign debt and how to control it was not a new problem for Indonesia. In 1991, the technocrats, following the advice of the World Bank, had created a mechanism to control the influx of foreign capital that involved indebtedness. After the financial reforms at the end of 1988, which liberalized new entries into the banking sector, the rate of growth in the money supply exceeded 40%. The monetary authority, fearing inflation and a currency crisis, tightened its monetary policy. As a result, domestic interest rates soared, and a gap arose between domestic and foreign interest rates. This stimulated a large capital inflow into Indonesia, and starting around the end of 1990, some observers in the Euro markets began to raise concerns about the country risk of Indonesia. Hearing of this, the World Bank sent the memo to the Indonesian government on January 21, 1991:

"Deregulation does not mean that regulations and oversight are unnecessary. It is extremely dangerous to leave the question of how much Indonesian banks or companies overall can borrow up to the markets (that is, foreign lenders). When the market decides that it has reached its limit, it will already be too late. Indonesian borrowers will be unable to refinance their loans, and the country will probably be unable to guarantee its foreign currency reserves at a high level. In the worst case, it will become necessary to reschedule the debt[4]."

Based on the World Bank's advice, the Indonesian government canceled or postponed several major projects, and in September 1991, it set up the Offshore Commerce Loan Management Committee (abbreviation: PKLN), with Coordinating Minister Radius as its chairman. The PKLN created ceilings on foreign borrowing for state-owned companies, private companies, state-owned banks, private banks, and the government. But there was one problem with the PKLN; it had no mechanisms for ensuring implementation of the ceilings for private companies. As we will see later, the ceilings for state-owned companies and banks were effective.

The problem was with the private companies, which were required to report foreign borrowings to the PKLN. That is, there were no rules or penalties stipulated for failure to report for private companies. The main reason is that, as of 1991, it was considered important to control borrowings by major projects that the government participated in. Borrowings by private companies were not considered to be significant.

In any case, external borrowings by private companies proceeded at a rapid pace. After 1994, when it would have been most necessary, there were no moves to modify the PKLN's mechanism. Foreign borrowing by private companies was allowed to proceed unhindered, only to cause the shortage of the dollar in October 1997[5]. In order to halt the decline of the rupiah and sweep away the feeling of pessimism about it, the Indonesian government made an official request for support to the IMF on October 8.

2. Cooperation between the Technocrats and the IMF: from October 8 to January 6

2-1. Designing the IMF Program: from October 8 to October 31

As can be seen from Fig. 2, after the request for support to the IMF, the rupiah-dollar rate stabilized at around 3600, and Fig. 3 shows that the value of the speculation index, which had been near 10%, fell below 5%[6]. The markets adopted a position of waiting to see what sort of policies the Indonesian government and the IMF would hammer out concerning the stabilization of the rupiah. The nightmare scenario of a continuous self-fulfilling process of rupiah depreciation and anticipation receded into the background. In other words, the monetary authority was within reach of stabilizing the rupiah by choosing appropriate policies.

The leader of the Indonesian team that aimed for stability of the rupiah and structural reform was Widjojo, a leader of the technocrats. This demonstrated that Sadli's law — "During a crisis, the technocrats promote reform" — was as valid as ever.

In order to stabilize the rupiah, the Widjojo's team first secured 33 billion dollars worth of assistance from the IMF, the World Bank, the Asian Development Bank, Japan, Singapore, and the United States. At that point, Indonesia had 24.5 billion dollars of foreign currency reserves of its own, totalling 57.5 billion dollars in all. They believed that this would be enough to meet speculative demand for funds and that speculative forces would quiet down.

The reform of the banking sector was most important among the many structural reforms. Since 1991, the Central Bank had gone to great lengths to enhance prudential regulations. For example, on the surface, the percentage of banks not observing the lending limits for conglomerates decreased from 25.8 percent of over two hundred commercial banks in 1992 to 13.8 percent in 1995. However, the actual situation was just the opposite: almost all these banks were affiliated with the conglomerates and their business practices were problematic. The banks which were especially bad among them began to suffer serious financial difficulties since the beginning in August, as interest rates soared. They were taking in funds and paying interest rates of between 50 and 300 percent, when the inter-bank interest rate for sound banks was about 25 percent. The existence of these weak banks had become a destabilizing factor in the financial markets. With the support of the IMF, the Central Bank attempted to reform the banking sector all at once.

On October 31, the details of the agreement between the Indonesian government and the IMF were announced. They included the closure of 16 banks, including one managed by Soeharto's second-oldest son.

2-2. The First Test of the Program: from November 3 to December 8

On November 3 (the first business day after the conclusion of the first agreement with the IMF), the central banks of Japan, Singapore, and Indonesia jointly intervened in the foreign exchange market in Singapore and strengthened the rupiah-dollar rate from 3615 rupiah (the closing value on Friday, October 31) to 3273 rupiah (Monday, November 3) in an attempt to cut through expectations that the rupiah would depreciate.

Judging from what happened later, the intervention was unable to maintain the rupiah-dollar rate at the 3200 rupiah level. The rate rose steadily,

Fig. 2 The rupiah value of the US dollar

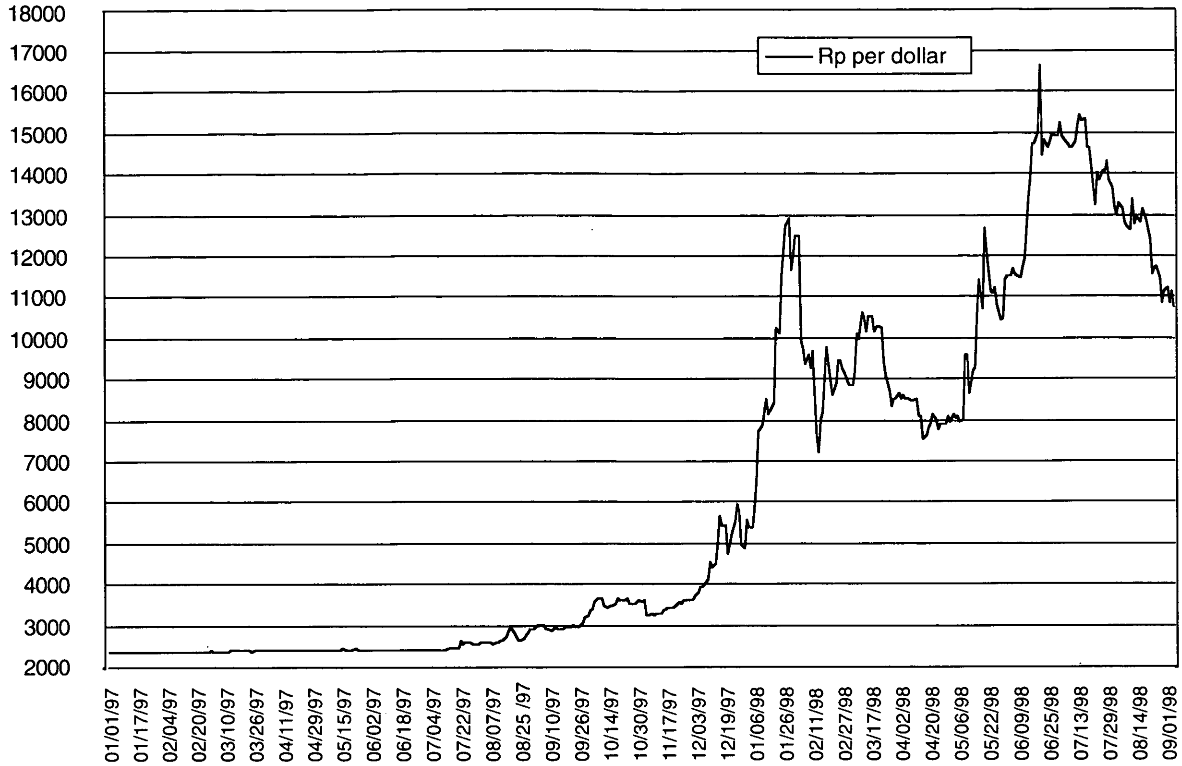
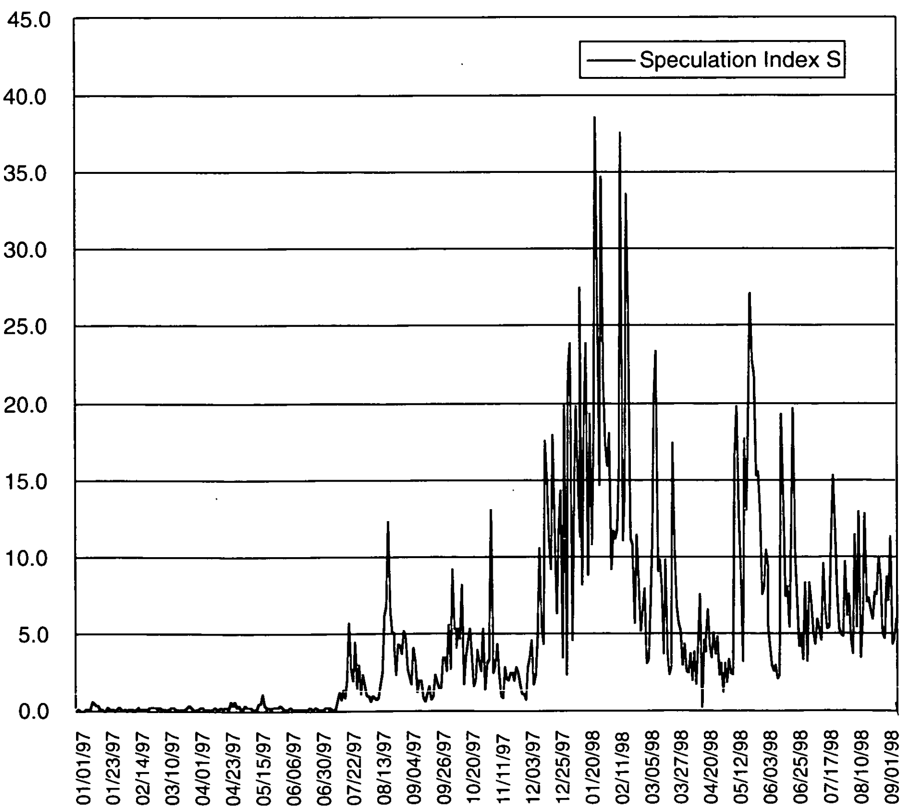


Fig. 3 Speculation Index S(t)



and after November 20, it returned to its pre-agreement level (3600). Once again there was an increased demand for dollars.

But the main reason that the rupiah continued its steady deprecation, despite the intervention of the monetary authorities of Japan, Singapore, and Indonesia, was an intensified speculative attack on the South Korean won, which rebounded to the currencies of all the ASEAN nations in November. The South Korean won was operating under a floating exchange system in which the daily range of fluctuation was limited. But in November, the fall of the won repeatedly bumped up against the 2.25 percent limit and trading was suspended. On November 17, the rate broke through the 1000 won to the dollar level. On November 20, the South Korean government broadened the daily fluctuation range from 2.25 percent to 10 percent and asked the IMF for assistance.

As speculative trends intensified throughout Asia, maintaining the dollar-rupiah exchange rate at the 3300 rupiah level became increasingly difficult. For that reason, the monetary authorities of the three nations suspended their interventions in the rupiah market "until the Asian currency markets as a whole have stabilized." After that, the rupiah continued to depreciate steadily, and on December 8, the closing value passed the 4000 rupiah mark.

If we look only at the rupiah-dollar rate, the early November policy of guiding the rupiah to the 3300 level through intervention in the foreign exchange markets failed. However, the joint interventions in the market succeeded in breaking the vicious cycle of expectation bringing about its depreciation and that, in turn, leading to expectation of further depreciation. At least as far as the exchange rate is concerned, the program that the technocrats and the IMF devised jointly passed the test. At least, it seemed that way.

However, when it came to the banking reform, things were headed in an unfavorable direction. There were widespread runs on banks, and both the total funds in the banking sector and M2 fell in absolute terms. This was quite abnormal for an inflationary period. The reform program for the banking sector ended up destabilizing the financial markets and lowering the reputation of the Indonesian banking sector as a whole[7].

In November, however, feeling reassured that a large package had been put together to support Indonesia, Soeharto revived the infrastructure projects that had been postponed in September. He also showed no enthusiasm for structural reform, much to the disappointment of the technocrats and the IMF. Soeharto paid little attention to the fact that the 33 billion dollars had not been given unconditionally but was subject to program review.

2-3. The Second Test of the Program: December 9 to January 6

On December 9, a rumor spread that President Soeharto was gravely ill. On the 12th, he canceled his attendance at the ASEAN summit. During those four days, the rupiah-dollar exchange rate passed 5000 rupiah. A change of presidents in March of the next year became an actual possibility, and the exchange rates began to reflect the political risk accompanying a change of the president and the government's loss of ability to manage a crisis.

The vicious cycle of expected depreciation followed by actual depreciation, which seemed to have disappeared, started up again. On December 24, the dollar-rupiah rate broke through the 6000 level, reaching a high of 6152 rupiah to the dollar.

The problem of foreign debt repayment by private companies began to resurface, impelled by the political shock of Soeharto's retirement. The IMF program failed to address the foreign debt burden, despite the fact that it was a fundamental part of the currency crisis. "The concern that the depreciation of the rupiah will increase the foreign debt repayment burden strengthens the demand for dollars, actually bringing about depreciation of the rupiah, and increasing the foreign debt repayment burden. Anticipation of difficulty in repaying the foreign debt will make it actually difficult to roll over debt and borrow foreign funds and will make the supply of dollars ever thinner. But this will result in further depreciation of the rupiah." This is what the technocrats and the World Bank had feared in 1991. It became a reality in 1997. But what were the technocrats to do, now that a currency crisis had occurred? Table 1 shows the size and breakdown of the foreign debt at the end of December. The amount of private foreign debt was 74 billion dollars[8]. The Central Bank knew the approximate number. What the markets could not see was how the Indonesian government was going to handle this fundamental problem of repaying foreign debt. Would it just ignore it?

Table 1 External Debts Balance

	Bil. of US$	%	%
Total	137.4	100.0	
Debts in Public Sector	63.5	46.2	
Debts in Private Sector	74.0	53.8	100.0
Debts on Foreign Banks	62.0	45.1	83.8
Debts by Indonesian national banks	8.4	6.1	11.4
Debts by Indonesian corporate sector	23.1	16.8	31.2
Debts by foreign and joint ventures	30.5	22.2	41.2
Debts on foreign investors (CP, Bonds)	11.9	8.7	16.1

Source: Bloomberg, February 6, 1998

The program that the technocrats and the IMF hammered out together failed to stabilize either the banking sector or the exchange rate. The financial markets lost all cohesion and split into a number of different strata. The self-fulfilling process of rupiah depreciation began anew, and the government was no longer able to control it. The program created by the technocrats and the IMF had failed its second test. Soeharto's distrust of the technocrats and the IMF manifested itself in his firing of four directors of the Central Bank, including the one responsible for foreign exchange policies. Sadli's law "During an economic crisis, the technocrats promote economic reform" was predicated on Soeharto's reliance on the technocrats. That presupposition began to fall apart, and Indonesia passed into a phase to which Sadli's law no longer applied.

3. The Confrontation between Soeharto and the IMF: January 6 to May 21

The year 1998 opened with an unfathomable situation in which the speculative index was nearly always over 10 percent. The exchange market had turned into a casino, with its actual function diminishing. Unable to absorb the shock of a change in the political regime, the first IMF program had failed to stabilize the rupiah. The underlying problems were many: the increasing seriousness of the foreign debt repayment burden that companies faced due to the depreciation of the rupiah, domestic interest rates of nearly 30 percent, the ensuing increase in the domestic debt burden, and a banking sector crisis due to increasing bad debts and runs on deposits. The first IMF program had not dealt with any of these problems directly. One could go so far as to say that the program itself had been a cause of the banking crisis.

Soeharto lost faith in the wisdom of the technocrats and the IMF. The IMF began to blame the failure of the program on Soeharto, saying that he had not been sincere in implementing it. From then on, until Soeharto's retirement in May, the course of events was determined by the interlocking confrontation between the two sides over the management of the increasingly severe economic crisis.

3-1. Soeharto's "Violation of the Agreement": January 6 to January 15

The budget for fiscal 1998 that Soeharto presented to the parliament on January 6, 1998, was a turning point in broadening the currency and financial crisis into an overall economic, social, and political crisis. Of course, it was not only the budget that created this turning point; the reaction that it provoked in the markets was also a factor. The market's evaluation of the budget was extremely harsh, and during the week of January 5 to January 9, including January 6, the dollar-rupiah exchange rate underwent a marked change, moving from a range of 6900 (high) to 5602 (low) rupiah to the dollar on January 5 to a range of 10,050 (high) to 7803 (low) rupiah to the dollar on January 9. As can be clearly seen in Fig. 4, from that time on, the rupiah-dollar rate stopped moving in concert with the baht, ringgit, and peso, and the depreciation of the rupiah proceeded on its own.

Why did the market display such an extremely negative reaction to the budget? The following newspaper article is a typical media reaction to the budget proposal:

> "President Suharto presented a draft budget to parliament yesterday that would breach targets agreed with International Monetary Fund and presumes exchange, inflation, and growth rates that many economists consider unrealistic." *Financial Times*, January 7, 1998.

More specifically, it was argued that three problems existed with the budget:

(1) The budget proposal which exactly balanced revenues and expenditures did not bring about a fiscal surplus of 1 percent of GDP, which had been agreed to in the accord with the IMF.
(2) The budget proposal did not clearly show the range and time period for increases in fuel prices and electric rates. This did not fulfill the conditions agreed upon with the IMF by which subsidies for petroleum products such as fuel were to be abolished and rates for electricity were to be raised 30 percent.
(3) The budget proposal presupposed macro economic conditions such as a 4 percent real growth rate, a 9 percent rate of inflation, and an exchange rate of 4000 rupiah to the dollar, but this was a much too optimistic view of the actual situation.

While the Indonesian media complained mostly about the third point, the foreign media paid special attention to the first two points. The Indonesian government's explanation that it was not violating the IMF agreement was, for all practical purposes, nearly ignored[9]. Publicly, the IMF made no comment. However, the following *Washington Post* article dated January 7 which quoted "the comments of a high-ranking IMF official" created a perception throughout the market that the budget violated the IMF agreement.

> "According to a high-ranking IMF official, 'The question for the markets is how strongly Indonesia's advisors are committed to a reform program, particularly reform policies of the sort that can exert influence on President Suharto's family.' . . .After reviewing Indonesia's performance, the IMF may refuse to pay the second installment of 3 billion dollars planned for the second half of March. Sources in the (U.S.) government have emphasized that they have not made any decision, the IMF official explained, 'That will be an important moment, not only for Indonesia, but also for all of us who are trying to get the current situation under control.' " (*The Washington Post*, January 7).

This article was widely quoted, and the perception spread that the budget proposal violated the IMF agreement and that the IMF might cut off its support[10]. What abetted and strengthened this perception was the barrage of telephone calls to Soeharto from world leaders, including Clinton and Hashimoto, urging him to abide by the IMF agreement. With this, the "violation of the IMF agreement" became a fait accompli, and Soeharto lost face.

The "market's" reaction to the budget proposal was not limited to the exchange market. On January 8, consumers who worried about price increases for daily necessities and shortages of goods swarmed into the supermarkets. It was clear that social unrest was spreading.

Hereafter, the pattern of confrontation between the government and the IMF over crisis management became an important characteristic of the policy formation process in Indonesia. Soeharto fell from his position of dictator and was no longer able to carry out important economic policy decisions without the agreement of the IMF. This was demonstrated symbolically in a famous photograph that appeared in the morning papers on January 16. It showed Managing Director Camdessus of the IMF with his arms folded, looking down at Soeharto in front of him signing the second agreement with the IMF.

3-2. The Second IMF Program and Soeharto's Resistance: from January 15 to May 4

Based on the January 15 agreement with the IMF, a program for reforming the banks and solving the problem of private foreign debt was announced on January 27. With this, it seemed as if there was going to be a way out of the deepening crisis.

However, these reform programs actually began to go into operation only in the latter half of March. From February into March, there was continued uncertainty about future economic policies. This was because Soeharto did not rely on the program that he had just agreed to with the IMF but instead jumped at the idea of a currency board, which his own children had brought up, and the IMF was opposed to adopting the idea of a currency board.

Soeharto had his own reasons for seizing upon the idea of a currency board. His choice to both sign the new accord with the IMF on January 15 and withdraw the budget proposal before it had been ever debated by the parliament, as well as a rapid series of presidential directives after January 15 to terminate support for the domestic automobile program and abolish the clove trading monopoly were all based on the belief that these measures would be useful for stabilizing the exchange rate and solving the economic crisis. Despite that, the exchange rate dropped further after January 15, and the foreign exchange market turned completely into a casino. On January 22, when the first Economic and Financial Resilience Council opened with Soeharto himself as the chairman, the rupiah continued to drop, despite intermittent intervention by the Central Bank. In one day the rate displayed extreme instability, ranging from a high of 16,000 rupiah to a low of 11,300 rupiah on January 22. The day's closing value was 12,150 rupiah, and value of the speculative index was 38.7 percent[11]. The foreign exchange market was fragmented into pieces, and the number of transactions dwindled, reflecting the fact that it was not functioning adequately for foreign currency transactions.

It was not only the foreign exchange market that was failing to function. The financial markets as a whole were malfunctioning, and this came to exert a negative influence on foreign trade transactions. Since the Indonesian banking sector as a whole lost its credibility, foreign exporters started to refuse the letters of credit issued by Indonesian banks. The country even became unable to import the raw materials it needed to produce exportables. The following article provides a particularly good description of the situation at that time:

> "According to bankers and analysts, the supply of dollars from Singapore and Hong Kong for Jakarta has nearly stopped, due to a fear that Jakarta's banks will fail. Foreign banks have cut the lines of credit for local Jakarta banks, and the Jakarta foreign exchange markets have split into three layers. The foreign banks in Indonesia are conducting transactions only with other foreign banks, and the local banks have been split between those that are comparatively untroubled and those that are in trouble. . . . The inter-bank interest rate also differs from group to group. 'What we are seeing is a gradual breakdown of Indonesia's credit system as a whole. Some foreign banks are giving up on Indonesia and leaving the country. That's because they think that the government is not trying to take any specific actions to solve the debt crisis and that it will take a long time to recover the debts.' " (*AFX-Asia/Indoexchange*, January 23, 1998).

As the crisis continued, with runs on banks and the banks borrowing from the Central Bank to cover the deposits that flowed out, it became clear that the currency board system. Central Bank support for the commercial banks must be suspended across the board, would be impossible to implement under the currency board system. Despite that, Soeharto stubbornly insisted on introducing the currency board. On February 17, he fired Governor Soedradjad of the Central Bank, who had been his contact with the IMF. The reason was his opposition to the currency board. Why, then, was Soeharto so insistent on having a currency board?

The confrontation between Soeharto and the IMF took the form of a theoretical argument about whether or not the currency board system would be effective in stabilizing exchange rates. A clown named Professor Hanke appeared on the scene and defended Soeharto's decision as the correct one. At the beginning of March, the United States sent former Vice-President Mondale to try to persuade Soeharto to stop his risky plan. In a general address to the People's Consultative Assembly on March 1, Soeharto explained his position as follows:

> "If I can lighten the steadily increasing burden on the daily life of the people, I'll make any choices that are needed. I have been implementing the economic and financial reforms supported by the IMF and intend to continue supporting them in the future. However, there are no visible signs of improvement. The key to solving the problem is to stabilize the exchange rate at a reasonable level. Unless we can do that, it will be difficult to improve the situation in the near future. That is why I am requesting the IMF and the foreign advisors to help us seek out a better set of choices. I call this better set of choices 'IMF plus.' " (*Jakarta Post*, March 2, 1998)

Reading between the lines, we can discern the perplexity of the leader who could not see the prospect of breaking out of these difficulties. The technocrats, who had usually helped Soeharto by writing prescriptions for finding a way out of economic troubles, were unable to find any effective policies for solving the problems. Soeharto insisted on the currency board, exactly because he could not see any future prospects under the IMF program.

On March 7, the IMF announced that it would postpone payment of the 3 billion dollar installment planned for March 15, giving as its reason the Indonesian government's failure to implement the agreement.

On March 8, Soeharto made a remark to the Unified Development Party, who was visiting him to ask him to accept nomination as the next president from the People's Consultative Assembly. He pointed out the possibility that the IMF program violated Article 33 of the 1945 constitution. (*Jakarta Post*, March 9)

On March 11, Habibie, Director of the Science and Technology, was promoted to vice-president, and on March 14, a new Cabinet composed of members of the inner circle of Soeharto was announced. In the market, an increasing number of investors anticipated the introduction of a currency board, and the direct confrontation between Soeharto and the IMF appeared to be inevitable.

However, Soeharto told Prime Minister Hashimoto, who went to Jakarta on March 15 to defuse the confrontation between Soeharto and the IMF, that he was not necessarily insisting on the currency board and that it was necessary for both him and the IMF to reconsider the program and be more flexible. A head-on confrontation between Soeharto and the IMF was avoided, and the two sides stopped playing the game of chicken.

On March 18, the new Cabinet and the IMF began reconsidering the program. People who had their own pet projects and who opposed the technocrat's reform policies were in the position of negotiating with the IMF. On April 8, a third program with new presuppositions and new conditions was agreed upon and launched.

During the more than three-month confrontation between Soeharto and the IMF, lasting from January to the beginning of April, the situation remained unclear, with no one knowing which policies the government would adopt, and companies and investors were placed in macro economic circumstances in which long-term decision making was absolutely impossible. No one was able to draw up a scenario of when the economy would hit bottom or by what route it would start moving toward recovery. As is clear from Fig. 4, due to a nearly 80 percent drop in the value of the rupiah as seen in dollar terms, the prices of tradables soared and real income dropped noticeably. The combined effect of higher prices and lower real income caused the domestic market for tradable goods to collapse. Amidst all this, industries that competed with imports in the domestic market, such as automobiles, were pinched by the soaring prices for imported raw materials and a collapse of domestic demand due to a fall in real incomes, and they seemed to have no future prospects at all.

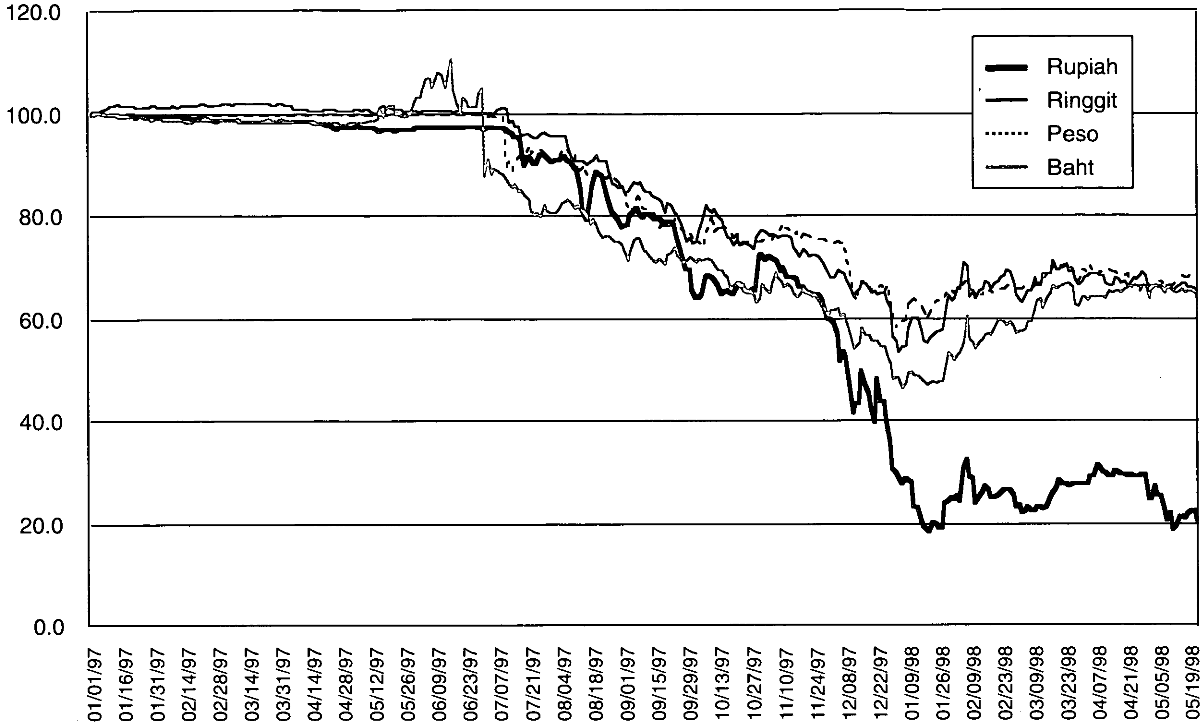
So how was the new third IMF program? Was it useful for making the government's policies more transparent and trends in the macro economic variables easier to understand and making the future outlook easier to see for companies and investors? The policies of the third program consisted mainly of the following six points:

(1) Tight monetary policies and higher interest rates (The SBI one-month interest rate, the benchmark for market interest, had been controlled to a level slightly above 20 percent since September 1997, but it was raised to 45 percent on March 25[12])
(2) Promoting structural reform of the banking sector
(3) Thorough structural reform of the economy, including bankruptcy procedures, competition policies, and the promotion of privatization
(4) Control of the budget deficit (One such measure required raising the prices of kerosene and gasoline by the end of June, with the additional conditions of abolishing subsidies for those petroleum products and raising fees for electricity by 30 percent)
(5) Creating a framework for restructuring private corporate debt
(6) Restructuring of foreign debt held by the banking sector

The program assumed that as a result of these policies, the rupiah-dollar rate would return to 6000, the real GDP growth rate would be 5 percent, and the inflation rate would be no higher than 50 percent.

With a head-on collision between Soeharto and the IMF avoided, the rupiah-dollar rate, which had been slightly over 10,000, began to fall after March 20, and the day after the announcement of the agreement about the third program, it fell to 8100. However, after that, the rupiah-dollar rate stayed at about 8000. Even when interest rates were

Fig. 4 Exchange rates in terms of the US dollar (January 1, 1997=100)



raised on April 20, it fell to the 7900 rupiah level for only a week and returned to the 8000 rupiah level the following week.

3-3. Soeharto's Last Gamble: From May 4 to May 21

On May 4, the government announced that the next day, public utility fees such as those for kerosene, gasoline, and electricity would be raised by 25 percent, 71 percent, and 20 percent, respectively. That day, the streets overflowed with cars trying to buy gasoline before the price went up, and Jakarta was plagued with traffic jams until midnight. On that same day, May 4, the Board of Directors of the IMF decided to pay Indonesia 1 billion dollars[13].

Beginning on May 5, a political movement seeking repeal of the price increases, reorganization of the Cabinet, and Soeharto's resignation spread rapidly. The financial markets were dominated by anxiety about the political turmoil that the increase in public service fees would provoke, and they completely ignored the IMF decision.

From then until May 21, when Soeharto was forced to resign, the political and social crisis continued to spread, and a state of anarchy broke out, with arson, violence, looting, and theft. Some of the foreigners working in Indonesia and Indonesians of Chinese descent, who were particular targets of the looting and violence, even fled the country, and economic activities stopped their normal operation.

Soeharto must have known that there was a risk of the price increases leading to political turmoil. For that very reason, he only argued for the necessity of an increase in prices in the first budget proposal in January and did not reveal any detailed schedule for it. So why did Soeharto, despite all this, make that dangerous gamble at a point when his political base was weak? Perhaps he was trying, in response to the chorus of foreign leaders telling him to honor the agreement, to prove that he at least had the power to do so. If so, in the end, Soeharto was forced into a dangerous gamble by President Clinton and the other world leaders who agreed with him. Soeharto's sending Mondale home empty handed at the beginning of March may have been a fatal mistake.

Whatever the case may be, Soeharto was forced to resign on May 21, abandoned by the Cabinet that he himself had formed, by Golkar, and by the military. His role in history had come to an end. Due to the political turmoil, the third program, despite a promising start, became unfeasible.

4. The Indonesian Government and the IMF: from May 21

With Soeharto's resignation on May 21, Vice President Habibie rose to the position of president. Under his administration, beginning on June 8, by which time the situation had calmed down a bit, representatives of the Indonesian government and the IMF began reassessing the program. Coordinating Minister Ginandjar remained in his post as a government representative.

That Ginandjar's remaining on the job appeared at first glance to provide some continuity to relations between the Indonesian government and the IMF. Yet relations between the two sides had fundamentally changed. When Soeharto was in power, any agreement between the Indonesian government and the IMF required his consent, and even after an agreement was concluded, Soeharto either had or believed that he had the freedom to revise it. The IMF had repeatedly criticized Soeharto for not observing the agreements, but that relationship came to an end. The people in the Indonesian government were no longer to take it upon themselves to modify or block implementation of any agreement that their representatives and the IMF had concluded.

On June 24, the Indonesian government and the IMF agreed upon a fourth program. The condition of abolishing subsidies by raising public utility fees by the end of June was changed to "according to a mutually agreeable schedule." According to the "mutually agreeable schedule," the Indonesian government and the IMF agreed not to raise the prices during the 1998 fiscal year, in order to strengthen the social safety net.

The bolstering of the Indonesian economy and thorough-going structural reform began with the support and advice of the IMF. On July 15, the IMF announced implementation of the billion dollar payout planned for June, along with 6 billion dollars of added support from the IMF, the World Bank, the Asian Development Bank, and Japan. On August 21, a comprehensive banking reform package was announced. However, due to the political crisis in May, economic conditions steadily worsened, and actual growth in the GDP for 1998 was predicted to be minus 14 percent, with an inflation rate of 80 percent, over 20 million unemployed, and over 80 million people below the poverty line.

5. Conclusion

The fundamental characteristic of Indonesia's policy formation process under the Soeharto administration, namely the rivalry between the technocrats and the technologists, disappeared along with Soeharto himself. The technologists, who were opposed to the technocrats' reforms, are carrying out historical economic reforms under the guidance of the IMF, the World Bank, the ADB, and the United States. How will this strange twist of fate influence Indonesia's future economic development? Even if the schema of conflict between the technocrats and technologists concerning strategies for modernization and industrialization has disappeared, the socio-economic basis for that conflict remains. One may wonder how the deregulation proceeding rapidly under the guidance of the IMF will affect the various social strata and economic sectors.

In addition, many reforms are well under way, as demanded by the IMF. But now that the technocrats are out of the picture, experts from the IMF and the World Bank, who know almost nothing about Indonesian society, are playing an important role in the process of systematic reform. However, these economic reforms are being carried out in a situation where no one knows how structural reforms aimed at establishing international standards will work under the social conditions prevailing in Indonesia. "We're using steel pipes, bricks, cement, trowels, and power shovels, all kinds of tools, and we're engaged in a construction project. But no one knows whether we'll end up with a house or a ship or anything that you can put a name to."[14]

With the future unclear, new political forces are being formed which control Indonesia's economic development strategies. As the general election planned for May 1999 approaches, it is believed that the political scene will gradually assume a clearer shape. One source of anxiety is reaction to the rapid deregulation. There is no guarantee that the newly impoverished people will not prefer protectionism over deregulation, subsidies over fiscal discipline, and unique Indonesian standards over international standards. There are many Japanese currently living in Indonesia who worry if Islamic fundamentalism might try to influence their economic activities in various forms through politics. The government and political parties of Indonesia have a huge responsibility for the future course of Indonesia.

At the same time, the analysis in this article shows that the various conditions that the IMF demanded have not necessarily been useful for stabilizing the Indonesian economy, but rather have been factors in broadening the currency crisis into a financial, economic, social, and political crisis and then exacerbating these crises. If the economy stabilizes and structural reform proceeds smoothly in the future, the IMF may well claim its great contribution. However, if recovery of growth is delayed, protectionism and populism come to the fore, inflation accelerates, and economic growth stalls, how will the IMF take its responsibility?

Notes:

1. The core group of the technocrats is referred to as the "Berkeley Mafia," and Widjojo, who played a central role in making Soeharto acknowledge the agreement with the IMF is a typical economist in that group. They are the free trade faction, opposed to the technologists, who advocate industrialization based on protection of domestic industries. From 1956 to 1959, the Ford Foundation supported an exchange program between the Economics Faculty of University of Indonesia and the University of California-Berkeley in the United States, and such promising young men as Widjojo, Ali Wardana, and Sadori studied at Berkeley. From 1968 to 1992, economists who had received their education in economics in American universities had a near monopoly on such important Cabinet posts related to Indonesia's economy as the National Development and Planning Agency and the Ministry of Finance and on the directorship of the Central Bank. On the other hand, the current president, Habibie (former Minister of Science and Technology) is a typical technologist. He belongs to the protectionist faction and has also been referred to as a nationalist.
2. "Indonesia Bites the Bullet," September 22, 1997, *Economic and Business Review Indonesia*. This article has the subtitle: "For the technocrats, economic difficulties are a blessing in disguise" at the beginning of the excerpt.
3. The amount of intervention has not been made public, but at the end of July, gross foreign currency reserves were approximately 29 billion dollars, slightly more than at the end of June.
4. The text containing this remarkably prescient memo is in "Cornell Southeast Asia Program" (1992) *Indonesia 1992*. It is extremely helpful for finding out the role that the World Bank played in advising the technocrats.
5. Why was there no attempt to alter the setup of the PKLN in 1994, when large amounts of foreign capital in the form of loans began flowing into private companies? Since the ceiling on the banking sector was strict, the private companies took in capital directly from overseas, and that will make it more difficult to deal with the problem. That is, since the PKLN refrained from dealing with the private companies, its very existence may have actually exacerbated the problem.
6. The speculative index for the daily rupiah-dollar exchange rate is calculated as (highest value-lowest value/closing value x 100). The graph of exchange rates uses the closing value, and the speculative index shows, by means of the ups and downs in the closing value, how much the exchange rate has moved. There are two situations in which the speculative index assumes a large value: (1) when the predictions of the market suddenly move sharply in a single direction, reflecting changing conditions, and (2) when the number of transactions decreases, the exchange markets fragment, and the exchange rate is controlled by accidental encounters, leading to widely varying daily values. In the latter case, the changes do not show one consistent trend: the rates move both up and down. The market's original function of determining rates from the aggregate of society's overall supply and demand is lost, and the market turns speculative, becoming nothing more than a casino. Actually, both (1) and (2) have occurred at the same time.
7. Depositors of the closed bank were guaranteed up to 20 million rupiah. Under the January 27, 1998 program, the full amounts of deposits were guaranteed.
8. On November 24, Central Bank Director Sudrajad revealed that as of the end of September, the amount of private foreign debt owed to overseas banks was 65 billion dollars, of which 9.6 billion was debt that would come due by March 1998.
9. Public finances were continuously in the black through fiscal 1995 and 1996, but at the budgeting stage, income and expenditures were in balance, according to the balanced budget principle. The Indonesian government took the position that the

goal at the budget implementation stage was a surplus. The increase in fuel subsidies was thought to be necessary for alleviating the effects of the economic crisis on low-income groups.

10. However, if this story is correct, the Indonesian government determined its budget over the IMF's opposition. During the budget revision process in November and December, the Indonesian government and the IMF should have come to an agreement about the budget plan, and if Indonesia was in violation of the agreement, the IMF should have protested before the budget was announced. However, according to remarks made by sources in the Indonesian government, the IMF did not take any such action. Then why did that high IMF official wait till after the budget was announced to make a pronouncement that raised questions about violation of the agreement? One possibility is that the IMF official was merely expressing his anxiety about delays in reform and did not understand what effect his remarks would have on the markets. This question is extremely interesting, simply because it brought about a turning point in the Indonesian currency crisis, but I was unable to find out anything more about it.
11. The direct causes of these extreme price shifts including a spreading sense of hopelessness in the markets about the fact that the IMF agreement announced on January 15 did not contain any clear measures aimed at the problem of private foreign debt along with anxiety about the selection of the vice president, which was entangled with the "post Soeharto" question.
12. On April 20, the one-month SBI was further raised to 50 percent, and the average of the one-month JIBOR rose from 35.9 percent to 50 percent on April 22.
13. This is part of the 3 billion dollars initially planned for March. It was to be paid out in three installments in May, June, and July. This was a device for strictly monitoring implementation of the program.
14. Heard at the Indonesian Financial Reform Agency (August 1998).

(Shinichi WATANABE)