

Indonesia's Implosion

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From Boom to Bust

The collapse of the Indonesian economy is one of the most stunning and shocking events to hit the developing world in the past several decades. Indonesia had achieved remarkable success since the early 1970s with sustained and broad-based economic and social development. Economic output had grown by an annual average of more than 7%, so that average income had more than quadrupled in the space of a single generation. Moreover, the benefits of economic development were widely spread. The share of the population living below the poverty line had fallen from well over 60 percent in the early 1970s to around 11% in 1996, the fastest decline in poverty rates anywhere in the world during the period. Infant mortality rates fell sharply, life expectancy gradually increased, and literacy rates declined. After years as one of the world's largest importers of rice, the country, remarkably, became self-sufficient (on trend) in rice production in the late 1980s. Standards of living rose rapidly, and almost everyone expected continued steady improvements.

And then, very suddenly and unexpectedly, everything collapsed in the latter half of 1997 and early 1998 in the onslaught of the Asian financial crisis. The extent of the turnaround is nothing short of astounding. Economic output is expected to contract by around 15% in 1998, after expanding 8% in 1996 and 5% in 1997. This single year collapse in growth is among the largest recorded anywhere in the world in the post-World War II period. Millions of Indonesians, many surviving just over the poverty line during the good times, have lost their jobs. Food production has been disrupted, both because of the crisis and because, by sad coincidence, the country faced a severe drought in 1997, compounding the economic misery. Prices for many export commodities, especially oil, have fallen sharply on world markets. Investors, both foreign and domestic, have fled to safer havens. The banking system is moribund, and thousands of firms are facing the prospect of bankruptcy and closure.

The economic crisis quickly cascaded into a political crisis in early 1998, culminating in a series of bloody riots in May 1998 and the resignation of Suharto as president after three decades of unchallenged power. In the aftermath, the myriad of political, legal, and economic institutions that had been carefully cultivated under his rule began to crumble. While some of these institutions had helped support sustained economic development, others were designed to stifle political dissent, secure military-backed order, and ensure financial wealth for those in his family and inner circle. The new President, B.J. Habibie, seemed to have only a tenuous hold on power, with few observers at first giving him much chance to survive even a few months. Indonesia's political culture and political systems are now under intense pressure. The contours of the new political landscape are far from certain. A range of possibilities exist, from the

emergence of a new strongman to replace Suharto (perhaps in the form of a military dictatorship), to a rise of Islam as a more potent political force, to a more participatory government with stronger parliament and corresponding institutional checks and balances.

Thus, Indonesia is facing both substantial economic chaos and fundamental political upheaval. The combination creates a volatile and uncertain environment which will take years to sort out. The economic situation cannot be resolved until the political environment becomes more certain. Investors, both foreign and domestic, but especially Indonesian Chinese that were the targets of extensive violence during the May 1998 riots, are unwilling to return much-needed investment funds until they are more certain of the long-term political outlook. At the same time, the continuing downward economic spiral only compounds the political tensions and anger, increasing the possibility of further violence and adding to the uncertainty of the ultimate political outcome.

What Happened?

Indonesia's success since the early 1970s was built on three pillars. First, the government supported agricultural development, and in particular rice production, by helping to introduce new "green revolution" technologies, building roads and irrigation infrastructure, and helping develop markets that offered remunerative prices for farm output. Second, prudent macroeconomic management kept the government budget basically balanced, inflation low, and the balance of payments healthy. Able managers steered the economy through the shoals of the oil price hikes and declines and the world debt crisis of the 1970s and 1980s far better than in most developing economies. Third, trade and industrial deregulation measures introduced in the mid-1980s allowed a wide range of firms to compete on world markets in the production of labor-intensive manufactured products. Firms producing textiles, garments, footwear, toys, furniture, and later, electronics, expanded rapidly, creating millions of jobs in the late 1980s and early 1990s and lifting many Indonesians out of poverty. With this foundation in place, Indonesia seemed poised to continue to develop rapidly into the early part of the next century.

So what went wrong? The seeds of Indonesia's implosion were planted in the late 1980s and early 1990s, just as the country was beginning to enjoy the fruits of its long development success. Two crucial changes took place. First, a series of financial sector and banking reforms were initiated in the late 1980s that led to a rapid expansion of the banking system. The number of banks more than doubled from 108 to 232 between 1988 and 1993, and the banks were given much greater leeway both in how they raised funds and in their lending decisions. These reforms provided several benefits: they reduced the costs of financial intermediation, provided a mechanism for many Indonesians to save and borrow through the financial system, and reduced the role of the state in lending decisions. However, the regulatory and supervisory capacity of the central bank and other related institutions could not keep pace with the expansion of the financial system, and was regularly undermined by political interference. The central bank either could not (because of a lack of trained personnel), or would not (often because of instructions from the Presidential circle), enforce basic prudential banking regulations. By the early 1990s, bad loans were on the rise, some banks were undercapitalized, and many banks were in violation of normal prudential standards such as the share of loans outstanding to affiliated companies. (It is worth

noting that the problem was not universal: many other banks were well run, solid enterprises). The financial sector came under growing stress, and little was done to redress the situation.

Second, an increasingly larger share of economic activity was controlled by the Suharto family and its close circle of allies. Of course, corruption and cronyism had long been features of the Indonesian economic and political landscape, but the nature of these relationships changed in the early 1990s. Previously, much of the crony activity took place through the military, and was centered on companies that controlled Indonesia's vast natural resources. However, as Suharto's children came of age in the late 1980s and early 1990s, they began to take control of an increasing share of lucrative business opportunities, first in natural resource-based activities, then manufacturing for the domestic market, and later in finance. As the economy continued to expand rapidly, and as Suharto himself became older and seemingly more insulated from criticisms, there were few constraints to stop the family empire from expanding rapidly.

Nevertheless, the Indonesian economy continued to grow in the early 1990s, mainly because of the underlying strength and competitiveness of export-oriented manufactured products that were not controlled by the family. Foreign financing poured in. But while a substantial share of this funding was directed towards legitimate, competitive industries, much of it financed the growing family empire. Foreign financiers, fully aware of the growing weaknesses of the financial sector and the corruption associated with Suharto family businesses, were more than happy to finance these activities. After all, they earned high profits on these loans, and presumed (along with everyone else) that these protected enterprises could not fail and would be able to make all their debt payments. A growing share of the foreign financing came with short-term maturity structures (less than one year), which allowed borrowers to take advantage of lower interest rates, with the presumption that the loans would be rolled over on maturity. Few borrowers hedged against the risk of an abrupt change in the exchange rate.

These growing problems made the economy increasingly vulnerable to a sudden withdrawal of short-term foreign financing. Corrective action was urgently needed. But as corrosive as these problems were, they were not nearly severe enough to bring about a financial crisis of the depth and severity that subsequently struck Indonesia. In the event, mismanagement of the crisis itself by both Suharto and the International Monetary Fund led to a much more severe crisis than was either necessary or inevitable.

When the Asian financial crisis was touched off in Thailand, Indonesia was first widely praised for its initial reactions and astute management. It floated the rupiah, eased foreign investment rules, and did not spend its foreign exchange reserves. Nevertheless, the same fickle creditors that had been pouring money into Asia quickly began to withdraw their financing, and the withdrawals turned into a regional financial panic. Borrowers with huge, unhedged foreign debts rushed to cover their positions, putting intense pressure on the currency. Indonesia had opened itself too fully to the inherent instabilities of the global capital markets without installing appropriate safeguards, and now it was paying the price. Still, almost all observers predicted that Indonesia would not be as severely affected by the crisis as its neighbors.

Then, in early October, the government decided to invite in the IMF. The IMF's involvement in

Indonesia has been nothing short of disastrous. Indonesia, like all countries, hoped to obtain three things from the IMF: sound policy advice, the IMF's public stamp of approval (to reassure creditors), and sufficient funds to help weather the storm. It got none of these. First, the IMF's policy prescriptions -- for example, the ill-conceived closure of 16 commercial banks in early November, and its overly-austere fiscal and monetary conditions -- simply worsened the panic, and undermined both domestic and foreign confidence in Indonesia's prospects. Second, even though the Fund had been generally extolling Indonesia's economy for years, it now announced a long list of problems describing all that was wrong with Indonesia. Many of the issues on which the Fund focussed had little relevance to the immediate financial crisis. Thus the IMF gave a public stamp of disapproval, rather than approval, thereby further unsettling nerves and encouraging capital flight. Third, while the announcement of the IMF program loudly trumpeted \$40 billion in financial support for Indonesia, most of it was empty promises. In the first six months of the program, Indonesia received a paltry \$3 billion, far from adequate to reassure anyone or to stop the panic. In a nutshell, the IMF took a bad situation and made it worse. In retrospect, Indonesia almost certainly would be in much better economic shape today if it had not sought the assistance of the IMF.

Suharto, of course, added mightily to the mess. He was unwilling to act decisively in response to the crisis. He consistently avoided steps that would have required substantial sacrifice by the family enterprises. He allowed his son to open a new bank within days of having another bank closed for gross violation of prudential standards. For several weeks, he publicly flirted with the ill-advised notion of establishing a currency board, and fired his respected central bank chief for not acquiescing to the plan. These steps undermined his credibility and fatally damaged the confidence of the international community and foreign and domestic investors. In the end, Suharto himself must bear the bulk of the blame for Indonesia's disaster.

Looking Ahead

Indonesia now stands at one of the most important crossroads in its development history. Economic conditions are deplorable, and the downward spiral apparently has not yet hit bottom. A range of issues require immediate and urgent attention. The banking system is essentially not operational, and large injections of capital will be needed to get basic lending operations going again. Corporations face a massive debt overhang, and will require widespread debt writeoffs and rescheduling to resume normal operations. Millions of Indonesians are facing the devastating combination of a substantial loss of income and rising prices (especially for food), so urgent actions are needed to create a social safety net for those most adversely affected. In the midst of all of this, Indonesians must rethink and redesign their basic political system and create a legitimate system of governance. The challenges are immense. Recovery will take a great deal of hard work and much luck. At best, it will take several years for the economy to return to its former dynamism.

There are, however, a few emerging signs of hope. Exports, for example, have begun to grow in response to the currency depreciation. The agricultural sector is slowly beginning to rebound. In the long run, Indonesia has much going for it, including a wealth of natural resources, a dynamic agricultural sector, and vibrant and competitive manufactured export industries. In the end, it

will ultimately overcome this crisis and once again move forward on the path of economic development.

For developing countries around the world, three key lessons emerge from the Indonesian crisis. First, financial liberalization must be undertaken with care. In Thailand and Korea, as well as Indonesia, haphazard financial liberalization left financial institutions weak, open to manipulation, and vulnerable to panic. Financial liberalization programs must be introduced much more slowly than, say, trade reforms or privatization. The financial system should expand only as quickly as the government's ability to properly regulate and supervise financial transactions. Legal systems must be strong enough to contain flagrant violations and abuse of prudential standards. Governments must take particular care to limit their economy's exposure to short-term liabilities, since these leave economies vulnerable to quick withdrawals and financial crisis.

Second, Indonesia's rigid, centralized political structure ultimately did it in. Paradoxically, Suharto's strong rule probably had been beneficial in certain crisis situations in the past, when he was able to move swiftly and decisively to nip problems in the bud and restore investor confidence. But as Andrew MacIntyre has pointed out, "a political system of this sort also entails real economic risks, for if the leadership begins to behave in ways that are damaging to investor confidence there are no institutional checks or balances to constrain it."¹ Indonesia's institutional structure could not combat the expansion of the Suharto family financial empire in the early 1990s, and could do little but stand by as Suharto's relationship with the IMF eroded irreparably in early 1998.

Third, the IMF is currently ill-suited to combat emerging market financial crises. It has had very little success in combating such crises in recent years. The rare exceptions (such as the Mexican peso crisis of 1994, and perhaps the Korean case in 1998) have had more to do with extraordinary international financial support or debt restructuring than the basic IMF approach. As emerging market crises shift from being government-centered (as in Latin America in the 1980s) to the private sector, new approaches are needed that more quickly contain fast-developing panics and restore confidence, without ensuring investors of being bailed out. The world has changed since the early 1980s, especially the world of international financial markets, and the IMF needs to change with it.

¹ "Wither Indonesia? What America Needs to Know and Do." School of International Relations and Pacific Studies, University of California, San Diego, August 1998.