

# Development Discussion Papers

## **Indonesia: Long Road to Recovery**

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## **Indonesia: Long Road to Recovery**

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### **Abstract**

This paper examines the collapse of the Indonesian economy in late 1997 and 1998, and analyses the most pressing economic problems inhibiting its recovery. It explores several weaknesses that emerged in the economy in the early 1990s, including a high dependence on short-term foreign borrowing, a weak banking system, a modestly overvalued exchange rate, and the seemingly unbridled growth of the business interests of the family and associates of President Suharto. These problems were serious, and they made the economy vulnerable to a significant slowdown. However, on their own, they cannot explain the magnitude and speed of the Indonesian collapse. Mismanagement of the crisis by the Indonesian government, especially President Suharto, and by the International Monetary Fund made the contraction much deeper than was necessary or inevitable. Looking ahead, the major ingredient necessary for economic recovery is a political stability, which depends on smooth parliamentary and presidential elections in 1999. On the economic front, the main challenges that lie ahead are the reorganization and recapitalization of the banking system, restructuring of corporate debt, stimulating exports, and containing the budget deficit.

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## **Indonesia: Long Road to Recovery**

The Indonesian economy collapsed brutally in 1998, shrinking by an estimated 14%. The speed and magnitude of the economic disintegration was stunning. The Indonesian economy had grown by an average of more than 7% per year between 1990 and 1996, and in it grew by 5% in 1997. The single year turnaround of 19 percentage points in economic growth in one year is among the most dramatic economic collapses recorded anywhere in the world since the Great Depression. Both foreign and domestic investors have fled, and hundreds of corporations are bankrupt. The banking system has effectively ground to a halt, with very little new lending taking place and dozens of banks insolvent. Imports during the first 11 months of 1998 were 35% below their 1997 level (in US nominal dollar terms), indicating the extent to which domestic demand has plummeted. Thousands of Indonesians have lost their jobs, and millions more face a substantial reduction in their standard of living. There is no immediate prospect of a quick economic rebound. The government has projected zero growth for fiscal year 1999/2000, but most private sector analysts have predicted that the economy will contract in 1999 by an additional 3-4%.

In early 1998, the economic crisis quickly cascaded into a major political crisis, with long-time strongman President Suharto resigning in May. In the political vacuum left after his departure, social tensions have risen and violence has become commonplace. Both parliamentary and presidential elections are scheduled to take place in 1999, but it is far from certain who will emerge as Indonesia's next leader, much less what type of political system will develop in the wake of Suharto's rule.

This paper examines the collapse of the Indonesian economy and the most pressing economic problems inhibiting its recovery. The paper was written just prior to the June 1999 elections, during a very fluid and volatile period of Indonesian history in which the future is very uncertain and difficult to foresee. The paper explores several weaknesses that emerged in the economy in the early 1990s, including a high dependence on short-term foreign borrowing, a weak banking system, a modestly overvalued exchange rate, and the seemingly unbridled growth of the business interests of the family and associates of President Suharto. These problems made the economy vulnerable to a significant slowdown. However, on their own, they cannot explain the magnitude and speed of the Indonesian collapse. Mismanagement of the crisis by the Indonesian government, especially President Suharto, and by the International Monetary Fund made the contraction much deeper than was necessary or inevitable. The last section of the paper explores several of the most pressing problems facing policymakers as they try to end the contraction and return Indonesia to a path of economic growth.

### **A Brief Economic History**

Indonesia recorded one of the fastest growth rates in the world between 1970 and 1996. The economy grew by 7.2% per year, propelling an annual increase of 5.1% in per capita income. As a result, real annual income for the average Indonesian was nearly *four times* higher in 1996 than it was in 1970. Moreover, compared to many countries, 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 year, while the average income of the entire population grew by 4.9% per year (Gallup, Radelet, and Warner, 1998).<sup>2</sup> Indonesia's rapid growth was translated into the largest reduction in poverty recorded anywhere in the world during the period. In 1970, over 60% of Indonesia's population were below the official poverty line, but by 1996 the share living in poverty had fallen to 11%, according to official estimates. Although some analysts dispute the precise magnitude of these numbers, no one doubts that Indonesia recorded a remarkable drop in abject poverty during the last three decades. A range of other social indicators bears out this success. Life expectancy at birth increased from 49 years to 65 years, adult literacy rates jumped from 57% to 84%, and infant mortality rates fell from 114 per thousand to 49 per thousand (World Bank, 1998a).

Four pillars provided the foundation for Indonesia's rapid growth. First, during the 1970s, the country primarily relied on its rich and diverse base of natural resources, including oil and gas, copper, tin, gold, rubber, and palm oil. Revenues from exports of these products financed widespread construction of roads and ports, an expansion of primary schools, and other infrastructure. While there was clearly extensive waste and abuse, Indonesia managed its resources far better than most resource-abundant developing economies during the 1970s and 1980s.

Second, agricultural output grew steadily starting in the early 1970s, supported by green revolution technologies that rapidly increased rice production on Java and some of the outer islands. The government offered remunerative and relatively stable prices to rice farmers, consciously preferring to offer farmers adequate returns rather than provide huge subsidies for consumers. It further supported agriculture with large investments in irrigation and other agricultural infrastructure, and by connecting villages to larger markets through construction of new roads.

Third, the government actively promoted a switch towards labor-intensive manufactured exports, especially beginning in the mid-1980s after the fall in world oil prices. Exports of textiles, clothing, footwear, toys, furniture and other products soared, providing thousands of jobs and establishing a conduit for the introduction of new technologies. Barriers to foreign investment were rapidly (albeit not completely) dismantled during the late 1980s and early 1990s, at least in many sectors. Indonesian firms quickly became more integrated with globalized production networks.

Fourth, able economic managers adopted prudent macroeconomic policies that kept the budget basically in balance, inflation low, exports competitive, and the current account deficit at reasonable levels. Effective economic management helped Indonesia steer through the difficulties of the steep oil price hikes and declines in the 1970s and 1980s, and kept the macroeconomy largely in balance right up to the onset of the crisis in mid-1997. The government essentially proscribed domestic financing for the budget, a strategy that kept both expenditures and monetary growth under reasonable control. Between 1992 and 1996, inflation averaged 8% per year, the budget balance was slightly positive, and the current account deficit averaged 2.7% of GDP.

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<sup>2</sup> Some analysts argue that the income of the richest two or three percent of the population grew faster than that of anyone else. Although this is entirely plausible (and in my own opinion likely) there are no data to support or refute this claim.

## **Emerging Vulnerabilities**

Although the Indonesian economy was growing rapidly and most macroeconomic indicators were relatively healthy, there were several growing problems.<sup>3</sup> Four areas stand out: large capital inflows, a large portion of which was on a short-term basis; a slightly overvalued exchange rate and slowing export growth; a weak banking system; and the rapidly-growing business interests of President Suharto and his family and close associates.

First, between 1990 and 1996 Indonesia received capital inflows averaging about 4% of GDP. Although these inflows were not nearly as large as those received by Thailand (10% of GDP) and Malaysia (9% of GDP), they still amounted to a large amount of capital for the economy to absorb. Right up until the onset of the crisis, foreign creditors were eager to provide financing to Indonesia, especially through bank loans. By mid-1997, Indonesia's total debt outstanding to foreign commercial banks amounted to \$59 billion. As shown in Table 1, Indonesian banks owed about \$12 billion of this amount, while Indonesian corporations owed about \$40 billion (with the balance of \$7 billion owed by the government). Although much of this financing was used for productive investment projects, a significant amount went to weaker projects, many of which were controlled by the Suharto family and their associates. Foreign lenders were more than happy to finance these projects, often without undertaking adequate risk analysis. In some cases, creditors provided financing to poor projects because they believed the projects carried an implicit guarantee from the government. More importantly, however, most creditors simply believed that rapid growth would continue, so that even marginal projects would be able to service their loans.

The key to Indonesia's vulnerability was the maturity structure of the foreign borrowing, rather than the total magnitude of these flows. Of the \$59 billion owed to foreign banks in mid-1997, \$35 billion was short-term debt due within one year. In addition to this amount, Indonesian firms had taken out substantial lines of short-term credit in foreign currencies from Indonesian banks, adding to the short-term foreign currency exposure of Indonesian firms. By comparison, foreign exchange reserves in mid-1997 totaled about \$20 billion, so short-term debts owed to foreign commercial banks were about 1.75 times the size of Indonesia's total foreign exchange reserves.

Indonesian firms found short-term foreign currency loans appealing since they generally carried relatively low interest rates. Firms assumed they would be able to easily roll over the loans when they fell due, and in fact they did so for several years until mid-1997. Indonesia's exchange rate system added to the appeal of short-term debt. In the mid-1980s, Indonesia adopted a crawling peg, and the rupiah depreciated between 3-5% per year with little variation in the trend. The predictability of the exchange rate made short-term dollar loans seem much less risky, and therefore much more attractive. This predictability also undercut the incentives for firms to hedge against their exposure to exchange rate movements. According to one estimate, hedging added about 6 percentage

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<sup>3</sup> For discussions of some of these issues in relation to the other countries affected by the crisis, see Radelet and Sachs (1998a and 1998b).

points to the cost of borrowing (World Bank, 1998b). Very few firms covered their exposure.

Indonesia's vulnerability was all the greater because its largest creditors were Japanese banks, which supplied about 40% of the total credit from foreign banks (Korean banks apparently were also large lenders, but the exact amounts are unavailable, since the BIS tracks Korea as a borrower rather than a creditor country). The underlying weaknesses of Japanese banks made them more likely to try and quickly pull their loans once the crisis started. Apparently, this may have been just what happened. In mid-August 1997, as Thailand reached agreement with the IMF on its first program, Japanese banks agreed to keep \$19 billion in trade and other credit facilities open for certain Thai commercial bank borrowers. Japanese banks did not want to be caught in a similar situation in other countries, and so they apparently began to withdraw their credits from Indonesia, Malaysia, and other countries in the region, helping to spread the crisis.

Indonesia's slowly-crawling peg contributed to the second problem area: a modestly overvalued exchange rate and slowing export growth. As prices for many non-traded Indonesian goods and services grew in the early 1990s, the rupiah became increasingly overvalued (Radelet, 1996). This trend accelerated after the US dollar began to appreciate against the Japanese yen in 1995, meaning that the rupiah was appreciating against the yen. Between 1990 and mid-1997, the rupiah appreciated approximately 22% in real terms (Radelet and Sachs, 1998a). Growth in Indonesia's non-oil exports slowed from an annual average of 26% in 1991-92 to 14% between 1993-95 to just 10% in 1996 and 1997. The overvaluation and export slowdown, although smaller than in the other Asian crisis countries, clearly pointed towards the need for some moderate adjustments to re-establish the international competitiveness of Indonesian firms.

Indonesia's third area of weakness was its financial system, especially its banks. Beginning in the late 1980s, Indonesia began a series of initiatives and reforms aimed at opening and expanding the financial sector. Privately owned banks were allowed to operate and compete directly with the large state-owned banks that had long controlled financial activities. The government substantially reduced (although it did not eliminate) the extent of state-directed lending, giving the banks much more leeway in their lending decisions. Bank capitalization requirements were eased, and the number of banks more than doubled to well over 200 between 1988 and 1993. The government also moved to deregulate equity, bond, insurance, and other financial activities, although these did not expand as quickly as banking. These changes were encouraged and generally applauded by the international community. Indeed, financial deregulation brought many benefits to the economy by diminishing the role of the state in allocating credit, providing Indonesians with many more options for financial services, and reducing the costs of financial intermediation.

However, the government did not develop the supervisory and regulatory capacity needed to keep up with the greatly expanded and more sophisticated financial system. Some banks – especially state-owned banks -- were undercapitalized or allowed to violate other prudential regulations without penalty. Several large business groups opened their own banks, using bank deposits to finance their own activities with little scrutiny. As a result, many banks had substantial exposure to affiliated companies. In addition, the state-

owned banks in particular had large exposures to firms controlled by the Suhartos and their friends, and few of these loans were fully serviced.

The problems in the banking system were relatively well known, and efforts were made between 1993 and 1997 to clean them up. In fact, some progress was made. Ironically, many banks were much weaker in 1993 and 1994 than they were in 1997 at the onset of the crisis. Non-performing loans rose quickly in the early 1990s, especially following a major monetary contraction in early 1991. But they declined in subsequent years as banks regained profitability and were able to write off some bad loans. For example, NPLs in privately owned banks fell from 11% in 1992 to 5% in 1996 as a core of relatively well-run private banks began to develop. The World Bank, in a report on Indonesia issued just before the onset of the crisis, concluded that “the quality of commercial bank portfolios continued to improve during 1996, albeit slowly” (World Bank, 1997).

Although Indonesian banks borrowed offshore, they had accumulated far less foreign debt by mid-1997 than banks in Thailand or Korea. Indonesian banks owed about \$12 billion to foreign banks in mid-1997, compared to the \$26 billion and \$67 billion owed by Thai and Korean banks, respectively. One reason for this pattern is that in 1991, as foreign borrowing began to grow, the Indonesian government introduced limits on offshore borrowing by commercial banks, the government and state-owned enterprises. The government explicitly did not limit foreign borrowing by private companies, arguing that private sector borrowing decisions were best left to the market. Partly as a result, the vast majority of Indonesia’s foreign borrowing in the early 1990s was by private firms. Ironically, what seemed a prudent measure at the time may have partly backfired: when the crisis hit, it was much more difficult to restructure debts owed by Indonesia’s diffuse private sector firms than it was to deal with the more limited number of debtors (mostly banks) in Korea and Thailand.

Credit growth by Indonesian commercial banks was rapid, but not enormously so. Credit to the private sector grew about 20% per year in the early 1990s. By mid-1997, the total stock of claims outstanding to the private sector by Indonesian banks was the equivalent of about 56% of GDP, compared to over 140% of GDP in Thailand, Malaysia, and Korea. Lending in Indonesia financed a diffuse set of activities. Some loans financed large utility projects (especially in electricity generation), heavy industries such as petrochemicals, and consumer durables such as automobile assembly. Other loans went into property and real estate, especially in Jakarta, but there was not a property boom akin to that in Bangkok. As shown in Table 2, Jakarta property prices remained essentially unchanged in (US dollar terms) between 1992 and mid-1997. Still other loans financed the purchase of portfolio equities in the stock market. Again, however, the rise in stock prices was not abnormally large, registering a 7% average annual increase between 1990 and end-1996, and a 16% average increase in 1995 and 1996. By comparison, the yield on one-month central bank certificates averaged about 13% in 1995 and 1996. There was much less of boom-bust cycle in asset markets preceding the crisis in Indonesia as there was in Thailand. In this regard, Krugman’s (1998) description of the Asian crisis predominately a boom-bust story may resonate for Thailand, but is far from a complete story in Indonesia.

The third major weakness was the rapid expansion of the business interests of the family and close allies of President Suharto, especially his children. Of course, corruption and cronyism had long been features of the Indonesian economy. Special economic favors were given to the military and a small circle of businessmen throughout the 1970s and 1980s. In the late 1980s and early 1990s, however, Suharto's children came of age and became involved in a growing range of businesses, including shipping of oil and gas, production of petrochemicals, clove marketing, hotels, toll roads, and a plethora of other activities. The children seemed to be involved in almost every large business deal consummated in the mid-1990s. Foreign creditors were more than happy to lend them money, believing (with good reason) that the government was unlikely to allow their businesses to fail. Perhaps most importantly, Suharto seemed unwilling to reign in the children's businesses, even during difficult economic times. One of the hallmarks of Suharto's economic management in the past had been his ability and willingness to make difficult decisions and cut back on special favors to his cronies during economic downturns, but he seemed far less willing to do so when his children's business interests were at stake.

At a broader level, Indonesia's rapid economic development was not matched by similar political and institutional development. As President Suharto consolidated his power during the 1970s and 1980s, he tolerated no political opposition or discourse. Decision-making and power were extraordinarily centralized. The two opposition political parties were tightly controlled and offered only token opposition. Presidential elections were carefully orchestrated, with Suharto running unopposed in all seven of his election campaigns. Even after thirty years in office, he was never able to bring himself to groom a successor, and he failed to put into place any institutions that might ensure a smooth transition of power. His tight control extended to essentially all the most important legal, social, government, and business institutions.

In summary, Indonesia suffered from a growing number of problems in the mid-1990s, and adjustments and reforms were clearly required. As a result of these problems, a withdrawal of financing, a reduction in productive investment and a modest recession would not have been surprising, and perhaps would have been beneficial to the economy in the long run by helping to bring about needed adjustments. However, as significant as were these growing weaknesses, they do not, on their own, add up to an economic crisis of the magnitude that Indonesia experienced beginning in late 1997. Most of these problems were well known, and yet no one predicted a crisis in Indonesia. Even after the crisis started and observers had taken a closer look at the economy, few believed the situation would lead to a major contraction. For example, an IMF press release of November 5, 1997 -- several months after the crisis had started -- predicted economic growth of 3% in 1998. Sadly, it was not to be. To account for the full depth of Indonesia's collapse, one must look at how the Indonesian government and the IMF managed the crisis, and how, partly because of that mismanagement, the economic crisis quickly spun into a political crisis.

### **Crisis Management**

Indonesia was widely praised in the early stages of the crisis for taking swift and appropriate action. The government widened the trading band on the rupiah, then let it

float *before* it spent down its foreign exchange reserves in what would have been a futile and wasteful defense of the currency. It sharply raised interest rates in August, such that overnight interbank rates rose by a factor of six (for a brief period of time), from 15% at the end of June to as high as 98% on August 20th. Interbank interest rates remained at around three times their pre-crisis level in the months that followed, far higher than in the other crisis countries (Figure 1). The government postponed several large investment projects, and quickly eased restrictions governing foreign direct investment. Most observers believed that Indonesia would be much less affected by the crisis than its neighbors.<sup>4</sup> The IMF described Indonesia's initial response as "timely and broadly appropriate." In mid-October 1997, the central bank's foreign exchange reserves amounted to \$20 billion, about the same as they had been at the end of June. In other words, Indonesia did not make the same mistake Thailand had made, and Korea would later make, in using up its foreign exchange reserves.

Ultimately, however, the Indonesian crisis was badly mismanaged by both Suharto and by the IMF. Suharto's unwillingness to enforce policies that might damage the business interests of his family and close associates, his inconsistency, and ultimately his confrontational approach undermined confidence and accelerated Indonesia's economic contraction. The IMF's lack of familiarity with the Indonesian economy and its key institutions, and its poorly conceived reform program did the economy far more harm than good. Together, they took a bad situation and made it much worse than it should have been.

The first bad sign came before the IMF entered the scene, in early September. The government postponed 150 investment projects, only to announce several days later that 15 of the biggest would be allowed to go forward. The fact that Suharto's close associates controlled all 15 of these projects was an early indication that Suharto would resist reforms that directly affected his friends.

In mid-October, the government called in the International Monetary Fund, and the two parties reached agreement on Indonesia's first program on October 31. The government's decision to call in the IMF was curious: the central bank had not depleted its reserves, Indonesia's early handling of the crisis had been widely praised (other than the reversal of the 15 investment projects), and a relatively strong group of economic managers was in place. One possible factor was that these managers had some doubts as to whether Suharto would be willing to take action, and they brought in the IMF to provide support and pressure for what they assumed would be an appropriately designed reform program, accompanied by sufficient financing.

From the outset, however, the IMF program was badly designed to deal with Indonesia's basic economic problems of a loss of confidence of foreign creditors, rapid withdrawals of short term credits and a weak banking system. The IMF sent in a team of people unfamiliar with Indonesia and expected them to design a comprehensive economic restructuring program in about two weeks. Given this foundation, it is perhaps not

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<sup>4</sup> On September 5, 1997, for example, following the government's easing of foreign investment rules, the Asian Wall Street Journal ran the following headline: "In Battle for Investors, This is No Contest: Amid a Crisis, Indonesia Opens Up and Thrives as Malaysia Stumbles."

surprising that things went so badly. The IMF program had three basic components: tighter fiscal and monetary policies, financial reforms based on bank closures, and a range of other structural reforms aimed at specific sectors.<sup>5</sup> The first two merit some elaboration:

- ***Tighter fiscal and monetary policies.*** According to the IMF's press release, the first priority of the program was to generate a fiscal surplus of 1 percent of GDP. Putting tight fiscal policies at the top of the agenda was odd, since excess demand was not at the root of Indonesia's problems, and the capital withdrawals already well under way meant that the economy was already contracting significantly. The initial fiscal tightening simply added to the contraction, further undermining investor confidence in the short-term economic outlook and adding to the capital flight that was underway. Several months later, the IMF recognized this mistake and eased up on its fiscal targets in Indonesia (as it did in Thailand and Korea), but the initial damage had been done. The IMF also aimed to keep monetary policies tight. Overnight interbank lending rates, after their initial huge jump in August, fluctuated at around three times their pre-crisis level in September and October 1997 (a much larger rise in interest rates than in either Thailand or Korea, as shown in Figure 1), and they remained high after the IMF program was introduced. Furman and Stiglitz (1999) show that higher interest rates had little salutatory effect on the exchange rate in Indonesia, as hoped for in the IMF program. Higher interest rates did, however, weaken the financial condition of both corporations and banks.
- ***Financial reform through bank closures.*** As described earlier, there is little doubt that Indonesia's banking system was weak, poorly supervised, and in need of substantial reforms. Many banks needed to be closed. The important issues in October 1997 were which banks to target, how to close or merge them, *when* to do it, and how to otherwise restructure the financial system. The IMF program called for a sudden closure of 16 banks on November 1, 1997 in an attempt to send a strong signal to foreign investors that the government was serious about reform. Unfortunately, the closures were very hastily and poorly conceived, and were not accompanied by a comprehensive strategy to appropriately restructure the financial system (e.g., recapitalizing certain banks, restructuring the assets and liabilities of both the closed banks and those that remained open, protecting depositors, etc.). The bank closures backfired badly. In its preoccupation with sending a signal to foreign investors, the IMF ignored the fact that there was no deposit insurance in place and failed to take into consideration how depositors in other banks would react. The banks closures caused a series of bank runs (adding to the withdrawal of bank deposits which had been under way for several months) that seriously undermined the rest of the banking system, including healthy banks. The IMF later estimated that the closures sparked withdrawals of \$2 billion from the banking system in November and December, and caused a shift in deposits from private banks to state-owned banks (which depositors believed were safer). In addition, since it was not clear what would happen to the creditors of the closed banks, creditors of other Indonesian banks became more anxious to withdraw their loans. Far from engendering confidence, the closures

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<sup>5</sup> "IMF Approves Stand-By Credit for Indonesia." IMF Press Release number 97/50, November 5, 1997.

exacerbated the ongoing liquidity squeeze in financial markets, making it much more difficult for all banks to continue their normal lending operations. It is now widely recognized that the bank closures were a mistake, including by both the World Bank and the IMF.<sup>6</sup>

The IMF program was equally misguided on bank recapitalization plans. Before the crisis, Bank Indonesia (BI) had required banks to keep a minimum capital adequacy ratio (CAR) of 8% (the minimum standard recommended by the Bank for International Settlements), and had planned to increase the statutory minimum to 9% at the end of 1997. With the banking system clearly under a great deal of stress, and bank capital quickly eroding because of the exchange rate collapse, the IMF initially allowed for no forbearance. It not only required that Indonesian banks maintain an 8% CA, *but actually explicitly required that BI maintain the requirement of increasing the CAR to 9% at the end of December 1997*. This gave the banks just two months to recapitalize to *well above* their pre-crisis levels. Under the conditions prevailing in the market in Jakarta at the time, banks had little choice but to stop new lending, thus further adding to the economic contraction. Only after the banking system had seized up in January 1998 did the IMF finally consider temporary forbearance and allow BI to lower the CAR.

The bank closures were bad enough, but Suharto immediately made the situation worse. One of the closed banks was owned by his son, who publicly threatened legal action to keep his bank open. Within a few weeks, he was allowed to open a new bank (using the same buildings and employees!). This was taken as a clear sign that Suharto was not committed to taking the difficult decisions necessary to turn things around.

The government had a very difficult time managing monetary policy in the aftermath of the closures. Bank Indonesia, clearly stunned by the bank runs and without a comprehensive financial restructuring strategy in place, began to issue large amounts of liquidity credits to keep troubled banks open. Between November 1997 and June 1998, Bank Indonesia issued approximately Rp 130 trillion (around \$13 billion) of liquidity credits. These credits added substantially to the money supply and helped ignite inflation in early 1998. Moreover, while some of these credits went to relatively decent banks with legitimate needs, a significant amount went to banks owned by Suharto's friends.

The IMF later strongly criticized Indonesia for these large credits, with some justification, and frequently pointed to them as a sign that Indonesia was not willing to take strong action. However, to a very large degree, the liquidity credits were a direct result of the IMF-mandated bank closures (and lack of an adequate financial restructuring strategy in the IMF program). The IMF itself made the connection clear in its Memorandum of Economic and Financial Policies with Indonesia of January 15, 1998:

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<sup>6</sup> Goldstein (1998) concludes that Indonesia's mistake was that it did not close *enough* banks at the outset of the program. This argument ignores the fundamental problems with the IMF's approach: it was done too hastily, there was no deposit insurance in place, and there was no strategy for dealing with the liabilities and assets (both good and bad) of either the closed banks or those that remained open. In this context, closing even more banks would have stopped the payments system (and the economy) even more abruptly, and with more damage.

“Following the closure of 16 insolvent banks in November last year, customers concerned about the safety of private banks have been shifting sizeable amounts of deposits to state and foreign banks, while some have been withdrawing funds from the banking system entirely. [Para 15]. These movements in deposits have greatly complicated the task of monetary policy, because they have led to a bifurcation of the banking system. By mid-November, a large number of banks were facing growing liquidity shortages, and were unable to obtain sufficient funds in the interbank market to cover this gap, even after paying interest rates ranging up to 75 percent. At the same time, another smaller group of banks [author’s note: the state and foreign banks], were becoming increasingly liquid, and were trading among themselves at a relatively low JIBOR (Jakarta Interbank Offer Rate) of about 15 percent. As this segmentation continued to increase, while the stress on the banking system intensified, Bank Indonesia was compelled to act. It provided banks in distress with liquidity support, while withdrawing funds from banks with excess liquidity, thereby raising JIBOR to over 30 percent in early December, where it has since remained. [Para 16] Nevertheless, despite this increase in interest rates -- to levels higher than in any other country in the region - - the problems of the Rupiah have only intensified.”

These events demonstrate precisely why abrupt bank closures are such a bad idea in the midst of a panic: such changes, when taken quickly (and primarily for “demonstration” effects to show the government’s determination and resolve, rather than as part of a well-designed strategy) are likely to be poorly designed and badly implemented, and thus will add to the confusion and panic rather than reestablish confidence. Given these problems, it is ironic that Indonesia was later roundly criticized for not fully implementing the IMF’s prescriptions, since the government initially did exactly what the IMF demanded. The disastrous bank closures created doubts about the efficacy of the IMF program, and certainly added to the government’s reluctance to follow the IMF’s advice at later critical junctures.

An additional flaw in the original IMF program was that it provided only a very minimal amount of financing to ease Indonesia’s enormous liquidity squeeze. The newspaper headlines proclaimed that the international community had pledged \$xx billion in support, but in reality the amounts were much smaller. First, rather audaciously, the IMF counted \$5 billion as Indonesia’s contribution to its own program! Second, \$xx billion was “second line of defense” pledges from a variety of governments. None of this support materialized in the first year of the program. Third, and by far most important, the IMF planned to make very little financing available to Indonesia early in the program, when it was needed most. The first IMF program scheduled Indonesia to receive \$3 billion in November 1997 and nothing else for at least five months, with the next disbursement scheduled for March 1998. This was a woefully inadequate amount of financing to engender confidence and stop Indonesia’s panic. By comparison, Korea received over \$10 billion in financing and arranged a \$22 billion debt rescheduling in the first two months of its program, which immediately halted the financial panic in that country. Note that the small amount of up-front financing in Indonesia was *not* the result

of the political turmoil that developed in 1998, nor a penalty for non-compliance with the program. It was the explicit plan in the first IMF program of November 1997.

Following a brief rally after the signing of the first IMF program, the rupiah continued to depreciate and Indonesian stock prices continued to fall, more-or-less in line with movements in Thailand, Malaysia, and Korea. In early December, the signing of Korea's first program with the IMF led to renewed flight from Asian currencies, including the rupiah. The very next day, rumors of Suharto falling ill sent shudders through the markets, and stocks and the currency plunged briefly before rebounding somewhat the following week. Suharto's illness raised the possibility that he would be unable to lead effectively during the crisis, or that he might suddenly die without a clear successor in place. This sudden reminder of Suharto's advanced age and mortality, as well as the lack of political institutions to ensure a smooth succession, made investors very nervous and put new pressure on the financial markets. In retrospect, the illness also marked the beginning of the political crisis that would explode with great ferocity in early 1998.

The next big blow to Indonesia came in early January when the US Treasury and the IMF publicly and severely blasted Indonesia's proposed new budget that was based on a 32 percent nominal increase in spending. The Treasury statements sent the markets reeling, and the rupiah immediately plunged from Rp/\$ 6000 on January 2nd to Rp/\$ 10,100 on January 8th. It turned out, however, that the US Treasury's statements were very misleading, and had been made hastily without a full analysis of the budget. All of the increase in spending was simply due to pass through of the exchange rate movements (mainly due to debt service payments, aid-financed infrastructure spending, and a fuel subsidy). In real terms, the budget actually represented a decline in spending. Several days later, Deputy Managing Director of the IMF Stanley Fischer told CNN news that the new budget was "not as bad as it was being portrayed." Two weeks later the IMF quietly approved a new budget *with a 46 percent increase* in spending, but the damage to market perceptions had been done. The incident made clear that an antagonistic relationship had developed between the U.S. Treasury and the IMF on the one hand, and the Indonesian government on the other hand. It was at this point that the pattern of currency and stock price movements in Indonesia deviated very sharply from those in the other crisis countries, and Indonesia never recovered (Figure 2).

On January 15, 1998, Indonesia signed its second agreement with the IMF. The new program eased up slightly on fiscal policy and on the required capital adequacy ratio for banks, but otherwise kept the same basic strategy as the first program. The new program got off to a bad start during the official signing ceremony when Michel Camdessus, Managing Director of the IMF, leaned over Suharto, with arms folded, as Suharto signed the papers. This image offended many Indonesians and amplified the already strong anti-IMF sentiment among the general population.

When the details of the program were announced, the markets immediately reacted negatively, with the rupiah falling 11% in two days. One key reason was that there was almost nothing in the new program about a strategy for dealing with Indonesia's short-term foreign debt, which was at the heart of the market turmoil. This omission was all the more surprising given the success of the IMF/Treasury backed rollover of Korea's short-term debt that had been initiated just a few weeks before.

The difference in treatment of Indonesia's foreign debt from that in Korea and Thailand is stunning. With the strong support of the U.S. Treasury, Korea was able to roll over \$22.5 billion in short term debt owed by Korean banks and falling due in the first quarter of 1998. The rollover marked the turning point in the Korean financial crisis, as the currency immediately began to appreciate, stock prices rebounded, and, shortly thereafter, interest rates fell. Thailand received assurances in August 1997 (at the time it signed its first IMF program) from Japanese creditor banks that they would maintain credit lines of \$19 billion for foreign banks resident in Thailand (IMF, 1999a). The Thai government also managed to delay and/or restructure about \$4 billion in debts owed by the 56 finance companies suspended in the first IMF program (Institute of International Finance, 1999). In Indonesia, debt restructuring was not made a priority by the IMF until its third program in April 1998, at which point it was far too late. Some have argued that debt restructuring was put off in Indonesia because the fact that it was mainly corporate (rather than commercial bank) debt made the situation much more complicated, but that fact hardly justified ignoring the problem.

In late January, the government acted on its own and announced a "voluntary" suspension of private sector debt payments. At one level, this announcement changed little, since very few corporate debt service payments were being made by this time. Nevertheless, the announcement -- and the fact that it was not opposed by the IMF -- seemed to calm the markets. At the same time, the government announced that it would guarantee all commercial bank liabilities, including both foreign and domestic creditors and all deposits. Although the guarantees raised a number of significant problems, the government had little choice given the disintegration of the banking system that was underway. These two announcements finally provided a modicum of stability to the markets, and the declines of the rupiah and the stock market stopped, at least temporarily.

By this time, however, Suharto had adopted a much more confrontational approach and made it clear he was not going to fully adopt the program he had just signed. Even though there were good reasons to doubt the efficacy of the new program, his approach simply made market participants even more nervous, and the pressure on the rupiah continued. He waffled and backtracked on several structural reforms in the program, such as dismantling the clove marketing board (controlled by his son), removing tax breaks that heavily protected production of a national car (also controlled by his son), and other issues.<sup>7</sup> Most controversially, he began to flirt publicly with the ill-advised idea of introducing a currency board in Indonesia.<sup>8</sup> Suharto quickly latched onto the idea,

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<sup>7</sup> The IMF program called for a long list of structural reforms throughout the Indonesian economy. While many of these reforms were very beneficial to the economy in the long run (and had been pushed by reformists within the government for many years), they were of less importance than the bank and debt restructuring to the immediate crisis. Debate on these reforms distracted urgent attention from the key issues. See Feldstein (1998) for a discussion.

<sup>8</sup> A currency board system was clearly not appropriate for Indonesia in early 1998. The relatively large share of export revenues that Indonesia earns from a range of natural resource-based commodities make the economy vulnerable to rapid changes in its external terms of trade. With its relatively large share of non-traded and semi-traded goods, a rigidly fixed exchange rate system would mean that adverse external shocks would be translated into sharp increases in interest rates and economic contraction, rather than a smoother adjustment through exchange rate adjustment (as Indonesia frequently employed in the 1970s

despite widespread opposition both inside and outside the country. He did so perhaps partially because he thought it might be the silver bullet that its advocates promised it would be, but more likely because he hoped it could be used as a negotiating foil with the IMF. He also recognized that if a currency board were put in place, even temporarily, it would allow his family and friends to convert their assets to dollars at a more favorable exchange rate. Controversy over the currency board apparently was a major factor in Suharto's decision to dismiss the highly respected governor of the Central Bank, which further undermined confidence. The currency board controversy made it clear to investors -- both foreign and domestic -- that Suharto and the IMF had fundamental disagreements on the basic reform strategy, that there were differences within the Indonesian government as to how to proceed, and that the international community was not going to provide Indonesia with adequate foreign financing.

Indonesia's contraction was deepened by two additional economic shocks. First, the country was hit by a severe drought in 1997, which seriously undermined agricultural production just as the financial crisis was beginning to evolve. In particular, rice production fell sharply, leading to price increases that added significantly to overall inflationary trends. Weak farm production also meant that there were fewer employment opportunities for urban day workers that were laid off as the financial crisis began. During past economic downturns, it was common for unskilled urban workers to return to the family farm during economic downturns; this option was not attractive in late 1997.

Second, export prices fell sharply in 1997 and continued to be low throughout 1998. Weak oil prices, in particular, hurt both export earnings and budget revenue. Prior to the crisis, oil revenues accounted for approximately one-quarter of Indonesia's export earnings and about the same share of its government budget revenues. The fall in oil prices cost Indonesia approximately \$4 billion in export earnings in 1998. Prices also fell for a range of other export commodities, including plywood, copper, and rubber, leading to a loss of an additional \$3 billion in lost export revenues.<sup>9</sup> Total losses of \$7 billion were the equivalent of about one-seventh of total export earnings in 1997. To put this amount in some perspective, total disbursements from the IMF during all of 1998 were \$5.7 billion. In other words, IMF financing fell short of making up for lost export revenues from international price shocks, much less the massive withdrawal of private capital flows. The lost export exchange earnings clearly were an important factor in keeping downward pressure on the rupiah. This factor alone would have caused a substantial depreciation of the rupiah, even in the absence of the collapse of the banking system and the panicked withdrawal of foreign credits.

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and 1980s). Most importantly, two key prerequisites for a successful currency board were not in place in early 1998: adequate foreign exchange reserves and a functional banking system. Advocates of a currency board in Indonesia never made clear where they thought the needed foreign exchange reserves would come from, nor did they spell out a plan to reorganize the banking system in such a way that a currency board system could function effectively. Of course, had these prerequisites been satisfied, Indonesia's crisis would have been over. In the end, the currency board idea was fixated on the most obvious *symptom* of Indonesia's problems -- volatility in the currency markets -- and not the underlying problems themselves of excess short-term debt and a weak banking system.

<sup>9</sup> My thanks to Peter Rosner for supplying these estimates.

Although Suharto and the IMF both mismanaged the crisis, in the end Suharto must bear the brunt of the blame for Indonesia's debacle. For years he ignored calls to strengthen the banking system and moderate the economic largesse given to his family and friends. When the crisis started, he refused to make difficult choices and allowed the relationship with the international community to deteriorate beyond repair. Perhaps most importantly, his failure to allow the political system to mature and to groom an eventual successor set the stage for political disaster. His centralized control had probably helped Indonesia react quickly and firmly in past crises, 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" (MacIntyre, 1998). 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.

### **From Economic Crisis to Political Upheaval**

In January and February 1998, Indonesia's economic crisis began to quickly evolve into a major political crisis. In mid-January Suharto named B.J. Habbibe (the current president) as his running mate for the elections scheduled for March 1998. Market reaction was swift and harsh, since Habbibe was seen as being closely associated with large and wasteful government spending projects, rather than economic reform. Shortly thereafter, Suharto added to the uncertainty by firing the governor of the central bank. Doubts began to surface about his ability to grasp the gravity of the situation and provide the leadership that Indonesia needed. As the economic problems deepened, street protests and demonstrations became more commonplace, and increasingly became directed at ethnic Chinese.

Suharto named a new cabinet in March following his re-election to a seventh straight term earlier in the month.<sup>10</sup> He removed many of his economic managers and filled the cabinet with close associates and cronies, including his daughter and the head of the Indonesian plywood cartel. The composition of the cabinet was interpreted both domestically and by foreign observers as a sign that Suharto was much less interested in economic reform than in consolidating the power of his family and close associates. Domestic opposition became more vocal, and student protests began to flare up.

The situation became more chaotic in April and early May, larger and more frequent protests and growing calls for Suharto's resignation. In early May, Suharto raised fuel prices very sharply,<sup>11</sup> and the situation exploded. Several days of rioting and chaos culminated in Suharto's resignation on May 21st.

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<sup>10</sup> In Indonesia the president is elected indirectly by an Assembly which, until 1998, was comprised of 1,000 delegates, half of whom were the 500 members of the parliament. The other half were handpicked by the president, supposedly to represent various social groups and geographic regions. This body elected Suharto every five years by unanimous vote in each of his elections starting in 1968.

<sup>11</sup> The fuel price increases (although not their precise timing) was a requirement under the IMF program. The program specified that the price increases had to take place sometime between April and July (possibly in stages), not necessarily all at once in early May as Suharto decided to do..

Suharto's resignation created an enormous political vacuum, and several groups have been trying to fill the void. Social tensions have risen dramatically, and episodes of violence have spread throughout the archipelago. The new government has at best a weak mandate to govern, and key decisions have been delayed for long periods of time. Parliamentary elections are scheduled for June 1999, with a new presidential elections to follow later in the year. As a result, at best, the current political uncertainty will remain for some time to come, until at least early 2000. Rules on the formation of political parties and electoral representation are being changed, and the limits of political dialogue are being tested. Over 100 political parties have sprung up since Suharto left office, and 48 have been approved to contest the parliamentary elections. It is far from clear who will be elected president, and what form the government may take in the future. A range of possibilities exist, from the rise of a new strongman to replace Suharto, a military coup, the rise of Islam as a more potent political force, a nationalist/populist coalition, or a more participatory government. It is highly unlikely that the elections will produce a clear winner with a strong mandate to govern. The most likely outcome appears to be a coalition government with a weak mandate to govern. How long such a coalition would last is an open question. The struggle for power during the next year is certain to distract government officials and is likely to engender new street violence. Thus, Indonesia's current task is doubly difficult compared to other Asian crisis countries. Political and social leaders must simultaneously rebuild the shattered economy and fundamentally redesign the entire political system. It may take years for political and economic certainty to return to Indonesia.

### **The Economic Situation in Early 1999**

The economy finally began to achieve a modicum of stability in the last half of 1998. After depreciating to over Rp/\$ 16,000 in the aftermath of the May riots, the rupiah finally began to stabilize and appreciate in the latter half of 1998. In the six-month period between mid-September 1998 and mid-March 1999, the rupiah fluctuated within a (relatively) narrow band between Rp/\$ 7,000 and Rp/\$ 9,000. The main stock index increased 43% in rupiah terms between September 1998 and March 1999, although it was still 47% below its pre-crisis level in rupiah terms, and an astonishing 85% below in US dollar terms. Inflation, which reached as high as 80% on an annual basis in early 1998, dropped quickly in the latter part of the year. In the six-month period ending in February 1999, inflation was 20% on an annual basis. As the rupiah appreciated and inflation fell, interest rates finally began to decline, with the rate on Bank Indonesia's one-month paper dropping from 70% in early September 1998 to 37% in March 1999. Agricultural production rebounded following the disastrous 1997 drought, rice prices have fallen, and rice supplies are now adequate. Production of certain agricultural cash crops boomed in 1998, including rubber, cashews, cloves, coffee, and pepper.

While the relative stability has been a welcome relief, the economy may not have yet reached bottom. The economy is expected to continue to contract until at least the latter part of 1999, and perhaps until early 2000. New investment is negligible, as foreign creditors remain on the sidelines and domestic banks are unable to lend. Although there are many critical issues at this stage, five seem most important in terms of reinvigorating the economy.

1. **Political stability.** In the absence of a greater degree of political stability and certainty, the economy will not rebound anytime soon. Potential investors are simply unwilling to make significant commitments until they know what kind of government will emerge. Moreover, since a likely outcome of the election is some sort of a coalition government elected with a minority vote and with a weak mandate to govern, investment is likely to remain slow even after the election. Ethnic Chinese who fled after the May riots are in no hurry to return as the street violence continues. It is likely to be several years before confidence returns to anything close to the pre-crisis levels.

Political uncertainty has also affected the government's ability to implement crucially needed reform measures. At one level, the political reconstruction process is (necessarily) taking time and resources away from economic policymaking. In addition, however, the current government's weak authority has made it difficult to push through key policy changes, and is therefore delaying recovery.

The dilemma, of course, is that the relationship between political stability and economic stability runs both ways. Just as political stability is required for an economic rebound, economic stability (and some growth) is needed to help speed the return of political calm. For many years Indonesia enjoyed the benefits of a mutually reinforcing positive relationship between political and economic stability. With the onset of the crisis the reinforcing nature of that relationship turned negative. A fundamental challenge for Indonesia is to break the negative cycle and turn the relationship around. Progress on the economic and political fronts is likely to move forward in small steps, and will have to occur in tandem rather than in sequence, a process which will inevitably be both slow and halting. The parliamentary elections in June provide an opportunity for an important step in this direction.

2. **The banking system.** The banking system is essentially moribund, with most banks undercapitalized and illiquid, and normal lending operations seriously curtailed. Non-performing loans have reached as high as 60-75%, by some estimates. Over 60 banks have been closed, and dozens of others are under the supervision or management of the Indonesian Bank Restructuring Agency (IBRA). IBRA focussed its efforts in mid-1998 on beginning the process of recovering at least part of the Rp 130 billion in liquidity credits that Bank Indonesia had provided to ailing banks in late 1997 and early 1998. The owners of these banks have pledged \$16 billion in assets to the government to cover the loans. The owners have four years to repay the loans, or they will lose the assets. Although this mechanism should help the government recover at least some of the credits, the method for disposing of the assets has been hotly disputed.

In September 1998, the government announced its basic strategy to recapitalize the banking system. Banks will be separated into three groups. First, any bank with a capital adequacy ratio (CAR) of less than -25% will be closed. Second, those banks with a CAR greater than 4% will be allowed to operate normally, and will be expected to increase their CAR to 8% over the next several years. Third, banks with CAR between -25% and 4% will be eligible to apply for government recapitalization plans. Owners of banks in that category that meet certain eligibility requirements will be expected to immediately provide 20% of the funds necessary to increase their bank's CAR to 4%. The government will supply the remaining 80% of the recapitalization funds. The owners of the banks will have

the option to repurchase the government's shares within 3 years, and will have the right of first refusal to buy the shares through 5 years. In addition, these banks will be able to remove some of the NPLs off their books by swapping them for government bonds. Any amounts the banks collect on these loans can be used to buy back the government's capital share.

In early March 1999, the government closed an additional 38 banks and nationalized seven more banks. It announced that 73 of the remaining 128 private banks had met the minimum CAR standard of 4%. Nine banks were declared eligible for the government recapitalization scheme. The government announced that it plans to issue Rp 300 trillion (about \$35-\$40 billion, equivalent to about 30% of GDP) in bonds to recapitalize these banks (along with seven state banks, 14 regional banks, and 11 recently nationalized banks). Half of these bonds will carry a fixed interest rate of 3%; the other half will carry a rate of 3 percentage points about the rate of inflation. The budgetary costs for interest payments on these bonds, if the total value remains within the current estimate, will amount to about 3.5% of GDP. The IMF's estimates (as of late 1998) of the costs of bank restructuring for Indonesia and other countries in the region are shown in Table 3. Many observers, however, believe the ultimate costs in Indonesia will be higher than these estimates indicate.

These actions are major steps forward, and should help to put at least some banks on more solid footing. But there is a long way to go, with the future of many banks yet undecided. Even with the recapitalization, many banks remain illiquid, and have little incentive to begin lending. With one-month Bank Indonesia certificates trading at around 37% in mid-March 1999, most banks would prefer to put what little available funds they have in these instruments rather than in new loans. As a result, banking activity is likely to remain slow. Moreover, these moves constitute what is essentially a temporary nationalization of the banking system. The 73 private banks that currently meet the 4% CAR standard comprise only about 5% of bank deposits (IMF, 1999b). The remainder of the banks will be either fully or partially state-owned, at least for several years. For example, four of the seven state banks that existed before the crisis will be merged into one single bank which alone will manage 30% of banking system deposits. Extricating the state from the banking sector will be a major challenge in the coming years.

**3. Corporate debt restructuring.** Although the short-term foreign debt owed by Indonesian firms was at the heart of the crisis, almost nothing was done (with the exception of the voluntary debt suspension discussed earlier) about the issue until June 1998. At the end of June 1998 (the last available data), Indonesian firms owed about \$36 billion to foreign banks, down only slightly from the \$40 billion owed just prior to the crisis (see Table 1). Indonesia's short-term debt fell from \$35 billion to \$27 billion between mid-1997 and mid-1998 (BIS, 1998). Thus, even after a full year, the debt burden remained very high, both because debtors were unable to pay the debts and because creditors were unwilling to reschedule them. The amount of debt has undoubtedly fallen since June, but the burden remains very high.

In June, the government reached agreement (the "Frankfort Agreement") with a group of private creditors on restructuring Indonesian debt. First, Indonesian commercial banks were expected to repay \$6 billion in trade credit arrears, in return for which foreign banks would try to maintain trade credits at the (already depressed) April 1998 level (all

the new trade credits would be guaranteed by Bank Indonesia). Second, about \$9 billion in debts owed by Indonesian commercial banks and falling due before March 1999 would be exchanged for new loans of maturity between 1-4 years (also guaranteed by Bank Indonesia). These two facilities have been seen as generally successful, albeit at least six months too late.

The third portion of the agreement covered corporate debts. Indonesia established the Indonesian Debt Restructuring Agency (INDRA) to facilitate repayment of an estimated \$64 billion in corporate debt. INDRA acts as an intermediary between creditors and debtors and is designed to provide protection against further real depreciation of the rupiah (i.e., a rate of depreciation exceeding the inflation rate), and to provide assurances that adequate foreign exchange will be available to make payments. The plan provided little cash relief for debtors, and little incentive for creditors to write down their loans. To further encourage restructuring, the government announced the “Jakarta Initiative” in September 1998. The initiative offers guidelines on the formation of creditor committees, standstill arrangements, exchange of information, subordination of old loans to new credits, and other related issues. However, it did nothing to address the fundamental problem of burden sharing between debtors and creditors.

A major hurdle for Indonesian debt restructuring has been the reluctance of Japanese banks to offer any substantial debt relief or writedown on Indonesian debt. This problem is all the more pressing since Japanese banks are by far the largest of Indonesia’s creditors. Many Japanese banks were fairly weak to begin with before the crisis, and had not made adequate provisioning to write off substantial amounts of Asian debts. A common complaint since the onset of the crisis has been that when other banks were willing to move forward with substantial debt relief, Japanese banks would not agree. They have continued to insist that borrowers make interest payments on time, so that the loans will remain current in their books. Substantial progress in opening up the Indonesian debt log-jam may not be possible without more active participation and assistance by the Japanese government. More broadly, Indonesia’s debt burden has become so large that the country is likely to require significant formal debt relief in the future from the foreign creditors that helped fuel the crisis.

Despite these problems, there has been some halting progress in recent months. According to the IMF, by mid-March 1999 125 firms had entered negotiations under the framework of the Jakarta Initiative covering \$17.5 billion in foreign debt and Rp 7.8 trillion in domestic debt. Agreements were reached with 15 companies covering about \$2 billion in foreign debt and Rp 600 billion in rupiah debt (IMF, 1999b). While this is welcome progress, it is as yet just a tiny fraction of the amount outstanding.

4. **Exports.** One of Indonesia’s main hopes for a recovery was through an expansion of exports. The large depreciation of the rupiah substantially increased the international competitiveness of Indonesian firms, and made Indonesia one of the lowest cost producers in the world of many commodities and other products. Through the first three quarters of 1998, export performance was very strong, at least in volume terms. Export volumes were about 28% higher between September 1997 and September 1998 than a year earlier. Exports of furniture, chemicals, jewelry, pulp, and paper grew especially rapidly, and textile and garment exports also expanded. Indonesia’s export performance (in volume

terms) compared very favorably with the other Asian countries through late 1998 (see Table 4).

More recent information, however, suggests that the strong volume performance deteriorated sharply after mid-1998, at least for manufactured exports. Apparently, following the May 1998 riots, many foreign buyers became convinced that Indonesian firms could no longer be relied upon for timely delivery of products, and they switched their orders to firms in other countries.<sup>12</sup> Manufactured exports began to decline sharply in the middle of 1998, and did not show signs of recovery by the end of the year. In fact, the value of non-oil exports fell very sharply in January 1999 to about the same level as recorded in January 1995, four years earlier. Unfortunately, once foreign buyers switch their suppliers, it is very hard to convince them to come back, especially since the political situation in Indonesia remains unsettled. Here again, the June elections loom large, as they provide an opportunity to begin to convince buyers that Indonesian firms can again become reliable suppliers to world markets.

In addition to these recent problems with export volumes, export *prices* plummeted for many products, especially commodities, as discussed earlier. Most importantly, prices for petroleum products fell by about 50% during 1998. To a large extent, of course, the fall in world export prices is itself a result of the drop in demand in Asia. As a result of the price declines, and despite the strong growth in export volumes through the first half of the year, the US dollar value of exports fell 9% in 1998. Excluding, oil, the performance was only slightly better, with the dollar value of non-oil exports dropping 2% for the year.

5. **Budget deficit.** After years of prudent fiscal policy with essentially balanced budgets, Indonesia's budget deficit ballooned in 1998/99 to around 4% of GDP, and is expected to reach 6% of GDP in 1999/2000. Domestic tax revenues collapsed with the fall in economic activity. In addition, revenues from exports of oil (which accounted for 23% of total revenues before the crisis) fell by about one-third in US dollar terms. These two forces put tremendous pressure on the budget. There was little room to maneuver on the expenditure side (which was not unusually large by international standards before the crisis, at 14% of GDP). Debt service payments from previous government borrowing are the largest expenditure category, and could not be substantially reduced. Indonesia gained some relief by rescheduling some of its sovereign debts with the Paris and London Clubs in 1998, but there is little scope for further action on that front. Subsidies for certain consumer items (especially fuel) are another large expenditure item, but the government has little room to raise prices and reduce these subsidies without sparking renewed protests and violence. Moreover, with the crisis there are a plethora of demands for funds for critical social welfare programs. On top of this, of course, is the cost of recapitalizing the banks. The result is a huge deficit, with little immediate relief in sight. Receipts from new privatizations are unlikely to be large enough to make much of a difference. Any further depreciation of the exchange rate would only make the deficit larger. By contrast, an appreciation of the exchange rate, as many hope for following the elections, would help ease strains on the budget.

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<sup>12</sup> Thanks to Peter Rosner for these observations.

Financing the deficit is the most immediate challenge. There is not enough liquidity in the economy to float a major domestic bond issue. Monetizing the budget risks sparking inflation, which, under the circumstances, could jump very quickly. That leaves foreign financing as the only viable option. The government has received significant commitments from foreign donors, but another \$5 billion will be needed for the 1999/2000 fiscal year. Financing the budget will present a major challenge for several years into the future. At worst, the situation could lead to a sharp increase in inflation if the deficits cannot be financed. At best, inflation will remain in check, but the government's foreign debt burden will rise sharply.

Indonesia's political and economic challenges are enormous at this critical juncture of the nation's history. There are no quick fixes (like pegging the exchange rate) that will solve these problems. Indonesia must rebuild confidence one step at a time through a combination of peaceful and fair political transition, economic policies that maintain stability and rebuild shattered banks and corporations, and support from the international community. At best, Indonesia's road to recovery will be long and arduous. The crisis has meant several years (perhaps as much as a decade) of lost economic growth. However, with some luck, these economic and political transitions will help build the foundation for more sustainable long run growth and development in the future.

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**Table 1. Indonesian Debt Outstanding to Foreign Commercial Banks (billions of dollars)**

	Debt by Sector					Foreign Reserves (excl. gold)
	Total	Banks	Public	Non-bank Private	Short-term debt	
June 1997	58.7	12.4	6.5	39.7	34.7	20.3
December 1997	58.4	11.7	6.9	39.7	35.4	16.6
June 1998	50.3	7.1	7.6	35.5	27.7	17.9

	Banks Claims on Indonesia by Country of Origin					
	Total	Japan	United States	Germany	Other European	All Others
June 1997	58.7	23.2	4.6	5.6	16.9	8.4
December 1997	58.4	22.0	4.9	6.2	17.1	7.9
June 1998	50.3	19.0	3.2	5.9	16.1	4.2

Sources: Debt data: Bank for International Settlements; Reserves: International Monetary Fund

**Table 2: Stock and Land values, Indonesia**

Period	Stock Price Index		Capital Value: Grade A Office Space Jakarta (\$/m. sq.)
	Rupiah /1	US \$ (1990=100)	
End 1990	418	100	3019
End 1991	247	57	2788
End 1992	274	61	2327
End 1993	589	127	2402
End 1994	470	97	2358
End 1995	514	102	2179
End 1996	637	123	2250
End Q2 97	725	136	2267

Sources: DataStream & Jones Lang Wootten.  
1. JAKARTA COMPOSITE -PRICE INDEX

**Table 3: Estimated Costs of Bank Restructuring**

	Local Currency Cost /1	U.S Dollar Equivalent (Billions of U.S. \$) /2	Percent of GDP
<b>Interest Costs</b>			
Indonesia	40 trillion	5.4	3.5
Korea	8 trillion	6.4	2.0
Thailand	143 billion	4.0	3.0
Malaysia	3.5 billion	0.9	1.25
Philippines	11.9 billion	0.3	0.25-0.5
Total		17.0	
<b>Total Costs</b>			
Indonesia	300 trillion	40	29
Korea	74.7 trillion	60	18
Thailand	1583 billion	43	32
Malaysia	48.4 billion	13	18
Philippines	110 billion	3	4
Total		159	

Source: International Monetary Fund, "World Economic Outlook: Interim Assessment" December 1998

Notes:

1. IMF staff estimates as of November 30, 1998. The estimates include both budgetary and extrabudgetary costs and are intended to measure the up-front financing costs.
2. Converted at exchange rates on November 30

**Table 4.a: Export Growth (Values, \$)***(Percent Change from four quarters earlier unless otherwise noted)*

Country	1997:Q3	1997:Q4	1998:Q1	1998:Q2	1998:Q3	1998:Q4
China	20.5	14.0	12.6	2.5	-2.0	-7.3
Hong Kong	2.5	7.4	-0.9	-3.2	-10.4	-13.7
Indonesia	9.6	2.4	0.9	-8.4	-9.4	-16.5
Korea	16.1	4.4	8.4	-1.9	-10.8	-6.2
Malaysia	2.6	-5.4	-10.8	-9.1	-10.0	...
Philippines	24.3	19.6	23.5	14.4	19.2	11.5 **
Singapore	3.2	-3.9	-6.6	-13.9	-14.8	...
Taiwan	17.1	7.1	-0.3	-7.5	-9.6	-12.9
Thailand	5.4	4.3	-1.8	-6.9	-6.2	-10.0

Source: Export value data are from IFS. Taiwan's data are from WEO.

Notes: \*\* Export value data for 1998:Q3 &amp; Q4 is from National Statistics Office, Philippines.

**Table 4.b: Export Growth (Volume)***(Percent Change from four quarters earlier unless otherwise noted)*

Country	1997:Q3	1997:Q4	1998:Q1	1998:Q2	1998:Q3
China	...	...	...	...	22.1 *
Hong Kong	4.4	9.6	1.4	-0.5	-7.1
Indonesia	33.5	33.0	32.8	19.1	27.6
Korea	35.3	23.2	32.6	20.6	11.4
Singapore	10.5	7.8	7.6	-2.0	-0.7
Taiwan	9.7	11.4	3.8	0.8	...
Thailand	11.7	16.3	14.1	12.8	5.7

Source: Export volumes are from IMF (World Economic Outlook), except for China, which are from News Media reports.

Notes: \* Percent change during first 10 months over the same period in 1997.

**Figure 1. Exchange Rate, and Interest Rates  
(index, July 1, 1997=100)**

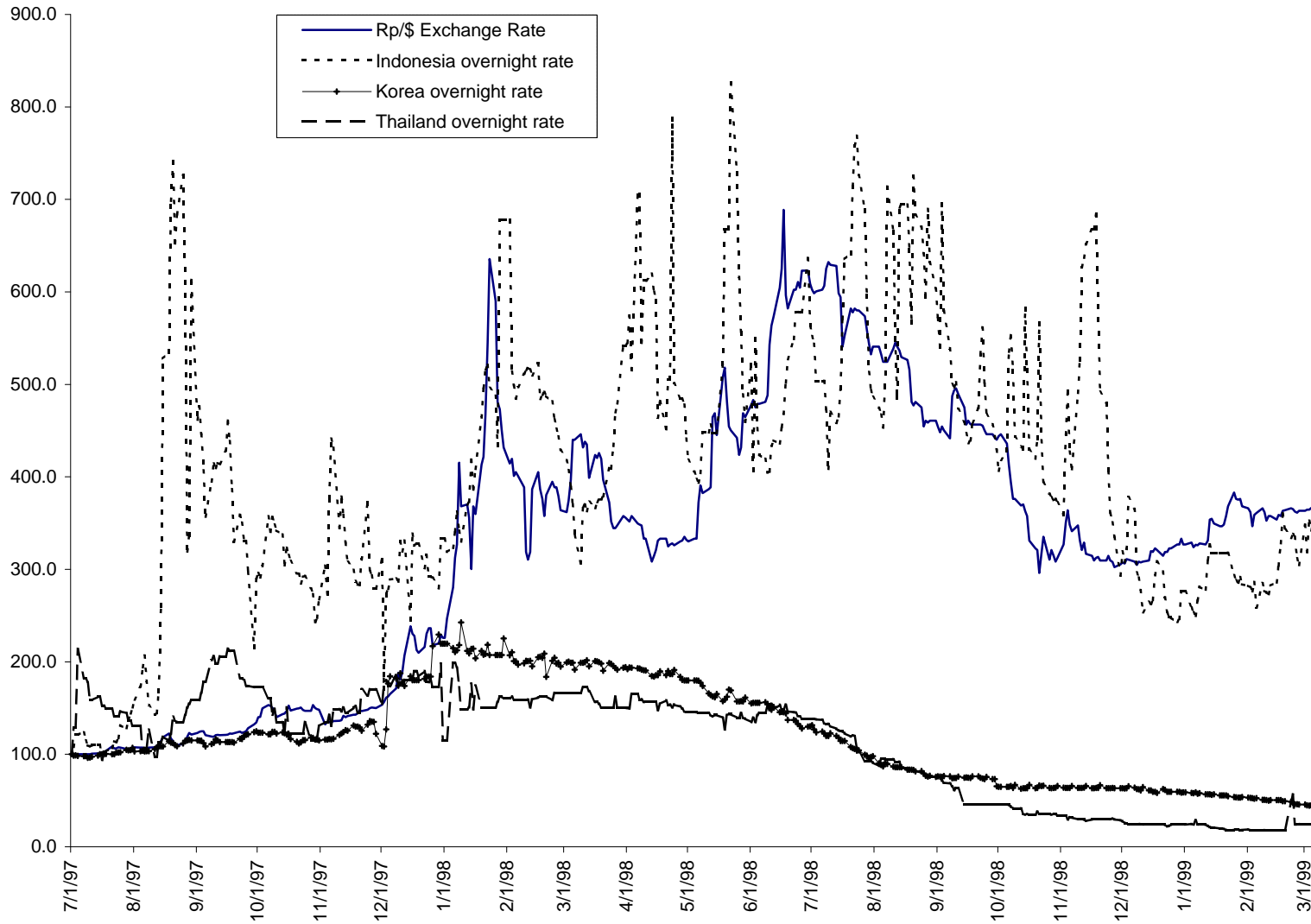


Figure 2  
Nominal Exchange Rate Index  
(July 1, 1997=100)

