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The IMF and the Indonesian Crisis

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Abstract

Given the strong performance and resilience of the Indonesian economy over the previous three decades, the depth and duration of the 1997–98 crisis was unexpected. The IMF's initial policy prescription was in keeping with the nature of the crisis—characterized by a reversal of foreign capital inflows, interacting with a weak domestic financial sector. But this prescription would work only if there was a quick restoration of market confidence. This was not achieved, and indeed public disputation over the elements of policy undermined confidence. Additional policy elements were needed that would address the capital outflows more directly and resolve the banking collapse. There was a loss of policy cohesion, between the IMF and the Indonesian authorities, and among the authorities themselves. Before alternative policies could be put in place, the political dimension became paramount.

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I. INTRODUCTION

The Asian crises of 1997–98 generated an extensive literature, much of it critical of the IMF. Now, six years on, the heat has gone from the debate. Some critics may have overstated their case. The IMF itself has developed and refined its defense and modified elements of its approach, and has adopted some of the proposals made by critics at the time (Lane *et al.,* 1999, Ghosh *et al.,* 2002, Boorman *et al.,* 2000). Of the three core Asian crisis countries assisted by the IMF, two (Korea and Thailand) are doing well again, and some might see this as a reasonable batting average.

The Indonesian crisis was surprising during the event and puzzling afterwards. This was a country that had experienced three decades of 7 percent annual growth, had coped successfully with a series of setbacks, had one of the longest serving and most experienced teams of economic policy makers, had no serious macroeconomic imbalances, and had adequate foreign exchange reserves. Why did it experience a crisis far more serious than its Asian neighbors—in terms of the fall in the exchange rate, the damage to the banking system, the fall in GDP and the tardiness of the recovery (and, it might be added, the move away from good economic policy)?

Much has been written already, often in the context of the wider Asian crisis.[2] This paper attempts to focus on a single aspect (although a multi-faceted one): what role did the IMF play? Such a narrow focus makes it inevitable that this story, taken by itself, will be partial and inadequate, and some will find it unfair. So it needs to be said at the outset that any comprehensive analysis of the Indonesian crisis would lay most of the blame for its severity on the Indonesian side. By the time the IMF became fully involved, a number of serious mistakes had already occurred. Perhaps more fundamentally, it is always the prime responsibility of the domestic authorities to get policy right, and the presence of the IMF does not diminish this responsibility. It might also be noted that, by and large, the policies the IMF advocated had the support of the Indonesian authorities.

Initially, and probably to a large extent even now, the IMF's failures have been seen in terms of overly high interest rates, overly tight fiscal policy, and overly strict structural conditionality.[3] With time, these initial heat-of-the-moment criticisms need modification. Modest interest-rate increases, temporarily tight fiscal policy, and some excessive structural

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[2] Without attempting a comprehensive enumeration, the following would be among the core sources. Blustein (2001); Goldstein (1998); Hill (1999); IEO (2003); Fischer (2001); Frécaut (2002); Kenward (2002); McLeod (1998); and Nasution (2002). More specific to the financial aspects are Cole and Slade (1998); Enoch *et al.* (2003); and Pangestu and Habir (2002).

[3] On interest rates, see Furman and Stiglitz (1998); on structural conditionality, see Feldstein (1998). For an overall assessment of these issues, see IEO (2003).

conditionality cannot, in themselves, explain the severity of the crisis or the damage that has been done to the policy making process. But if some of the criticisms leveled at the IMF are not deserved, it did make mistakes, which will be explored below. The point here is not to argue that if the IMF had "got it right" then the crisis would not have occurred or would have been significantly less severe. The judgments are made on a different and simpler basis: "Did the IMF offer the best advice?"

II. Initial Diagnosis

Following the onset of the Thai crisis, there were serious concerns among Indonesian policy makers that contagion might reach Indonesia. As far as we can judge, the IMF was less concerned, and was quietly confident that Indonesia could weather the storm. Thailand may have been viewed as being *sui generis*: the baht was seen as being overvalued before the crisis, while the rupiah was not. Perhaps more important, the IMF thought that the Thais had made a serious error in using all their foreign exchange reserves in the defense of the baht. Not only had Indonesia retained most of its foreign exchange reserves, but in August 1997 it had floated the currency—the action that the IMF had urged on Thailand in the period leading up to the crisis.

There were also the more longstanding factors: Indonesia had no serious macroeconomic imbalances—its current account deficit (CAD) was half that of Thailand and the budget was in balance—and the same policy makers who had seen Indonesia through 30 years of rapid growth were still in charge (if not directly, then through their legatees). The Indonesian policy makers had a reputation for being more effective (and having more clout) in tough times than in good times, as, for example, in the Pertamina crisis of 1975 (McCawley, 1976). Crises, however costly, offered opportunities for reform—the boundary between acceptable and unacceptable behavior could be shifted in the right direction, and institutional reform pushed through. To borrow from the management jargon, the opening phase of the crisis could be seen not as a problem, but as an opportunity.

The content of the IMF-supported program in Indonesia was influenced, above all, by the view that the situation was not serious and could be quickly restored by a sufficiently firm demonstration of policy probity on the part of the authorities, together with support from the international community.

It is hard, now, to comprehend just how mild the problem was judged to be. The best illustration of this is the GDP forecasts embodied in the program. Until the end of 1997, the assumption was that the economy would grow by 5 percent (only slightly more slowly than normal) in 1998. Forecasts made in January 1998 still predicted positive growth for that year; in fact GDP declined by 13 percent. The central issue here is that these forecasts (by the IMF, Indonesian policy makers and analysts, and others) failed to see the severity of the capital account reversal that was under way. To this central issue we now turn.

III. The Nature of the Crisis: Capital Flows

The Mexican crisis of 1994–95 had been identified by the IMF Managing Director as the "first crisis of the 21st century"—that is, a new phenomenon. The characteristic that made this crisis "new" was capital flows, a product of the extraordinary globalization of financial markets during the 1990s.

It was recognized that what happened in Mexico in 1994 (and what happened later in Asia) was different from the customary Latin American crises of the 1980s, where domestic policy mistakes were at the heart of the problem. Whereas the earlier crises had been addressed principally by correcting the policy imbalances ("adjustment"), the "crises of the 21st century" should be addressed by financing the abnormal outflow in order to restore market confidence (Ghosh *et al.,* 2002; Boorman *et al.,* 2000). In this sense, this type of crisis was analogous to a bank run, which, if the underlying position was sound, could and should be financed by central bank lending. The response would be largely in terms of financing, because a huge policy adjustment was not needed. Just as with a bank run, if the response on the part of the authorities looked decisive and the financing adequate, then the crisis would quickly stop, and the financing would not, in fact, be used.

In Mexico, the domestic imbalance (principally the budget) was corrected, the exchange rate was floated and moved to a new and more appropriate level, and very large financing ($50 billion) was available to handle the capital reversal. Not all of this was used, but it was available. The abundance of the available financing was central to the restoration of confidence: when it was clear that foreign borrowers would get their money back, the "bank run" element of the crisis was solved.

If Mexico provided a model for successfully handling the "crises of the 21st century," why was this success not repeated in Indonesia? One problem was that the largest participant in the Mexican rescue—the United States—was less highly motivated in this instance. Having completely missed joining the bilateral assistance program for Thailand in August 1997 (comprising the provision of funds by donors in addition to the IMF support), and still constrained by Congress's annoyance at the Administration's use of the Exchange Stabilization Fund to provide the money needed for Mexico in 1994, the United States joined the "second-line" contributions[4] for Indonesia in such a way that the market did not believe that any of this money was actually available.

In Indonesia (as in Thailand), the IMF recognized that financing should be the central element of the response, and made a considerable effort not just to put together a good amount of financing, but also to make it look even bigger (and in particular to make it look

[4] These "second line of defense" funds were similar to the Thai bilateral assistance funds, but were to be used only after the IMF resources were fully committed.

bigger than the perceived likely capital outflow).[5] By the standards of the time, the IMF's own contribution was large—$10 billion (490 percent of quota).[6] In addition there were World Bank/Asian Development Bank (ADB) contributions, recorded in the program as amounting to $8 billion (almost as much as that of the IMF). Much of this had to be redirected from existing programs; just how much was new or additional money (available to finance capital outflow) is not clear: $2 billion might be an educated guess (Kenward, 2002: 49). To these resources could be added Indonesia's own reserves (including a somewhat mysterious $5 billion not previously counted in reserves).

The rhetoric would need modification: the earlier criticism of Thailand for using its reserves would change for Indonesia. But even with the IMF's blessing for significant foreign exchange reserve use, it was clear to the markets that if no new private money came in and the short-term debt of over $30 billion was repaid quickly, there would not be enough funding to go around. (The IMF money was trenched rather than heavily front-end loaded, with $3 billion available immediately and a similar amount not to be disbursed until mid March 1998.) The IMF saw it very differently: it predicted that only $3 billion of private capital would leave in 1997–98, and $4 billion the following year. It thought that direct foreign investment would continue to flow in, so there would be a net capital inflow, and the assistance package could be simply added to reserves ("put in the shop window") to bolster confidence.

The outcome, of course, was quite different from IMF predictions. While it is difficult to put together reliable figures, perhaps the best measure (taken from Gosh *et al*., 2002: Figure 2.2) is that the private sector outflow in the first two quarters of the crisis (1997 Q4 and 1998 Q1) was equal to almost 25 percent of GDP, while official capital inflows (mainly the support package) were around 5 percent. So the central problem was analogous to a traditional bank run, but the resources available to the IMF were inadequate to provide the traditional solution.

The contrast between forecasts and outcomes shows most clearly in the balance between "adjustment" and "financing." The IMF expected a continuation of capital inflow at a rate consistent with a CAD of $5.8 billion (this was not too different from earlier years: the previous year had been $7.7 billion) (IEO, 2003: Table A1.2). In fact, Indonesia experienced a private capital outflow equal to almost 8 percent of GDP in 1998, requiring the current account to go into surplus equal to more than 4 percent of GDP (Ghosh *et al*., 2002:

[5] McLeod (1998: 40–1) paints a rather different picture of this episode, arguing that "there was simply no coherent strategy for using these funds."

[6] The norms of assistance were changing rapidly at the time. Korea was to receive over 1,900 percent of quota a few months later. Both Brazil and Turkey have current arrangements in the order of $30 billion, and Uruguay received a financing package equal to 20 percent of GDP.

Table 3.2). The program envisaged a minor slowing in GDP and a "pot-hole" in capital inflow that could be largely funded by official assistance. But the actual outcome required a CAD adjustment equal to nearly 10 percent of GDP (with the current account moving from minus 6 percent to plus 4 percent of GDP) over the first year of the crisis.

This highlights the central analytical point (which the IMF understood: see Boughton, 2001). If the outflow could not be stemmed or financed, then a combination of a big exchange rate depreciation and a big fall in GDP would be needed to bring about this sort of massive and immediate turnaround in the current account. Different combinations of declines in the exchange rate and GDP would have done the job but, given the urgency of the required adjustment, GDP reduction had to do most of the work. Whatever the combination, it was bound to be very dramatic indeed. As it transpired, the nominal exchange rate fell 80 percent (eroded over time in real terms by inflation) and GDP fell by 13 percent in 1998. Comparing this GDP change of minus 13 percent with the plus 5 percent that had been forecast at the start of the program provides the best summary measure of how far the program was off target. But it also provides the clearest reason why much of the post-mortem analysis misses the point: it is not necessary to search for reasons why GDP performed so badly (for example, because of the fall in private investment). It *had* to perform badly if the required current account adjustment was to be made.

Why was the capital flow forecast so far off target? Whatever Indonesia's idiosyncratic problems, this capital account behavior was a common factor in the Asian crisis countries. All three countries experienced huge capital reversal and had to undergo massive adjustment to put their current accounts quickly into very large surplus (a shift of more than 10 percent of GDP for both Thailand and Korea in the first year of the crisis). The inter-country difference was rather in their ability to bring about this adjustment, with Korea by far the most able, and Indonesia the least.

The Asian crisis countries had been part of the process of globalization of financial markets. Collectively they received capital inflows at a rate of $70 billion annually in the years leading up to the crisis (for Thailand this amounted to 13 percent of GDP in 1996, and for Indonesia, around 6 percent per year in the first half of the 1990s). Why didn't the IMF see that the Thai experience (the "wake up call" to investors who had previously been too optimistic) would be repeated in Indonesia?[7] The IMF probably assessed the Thai crisis as being driven by special factors, and so did not see it as a warning for Indonesia. The Korean crisis was a little later (and was handled with more "front-end" loading of the assistance and rollover of the foreign private bank lending). While the extent of the outflow could not be known beforehand, this should have been the central point in analyzing the crisis. This precrisis capital inflow was potentially volatile because it was largely herd driven, led by portfolio managers more interested in diversifying and rebalancing their portfolios than in making fine judgments about risk. "Emerging markets" had become the market favorites, and

[7] On contagion from Thailand, see McLeod (1998).

every portfolio manager needed to get up to weight, without too much regard for the quality of the investment. The problem was that these markets were tiny (Volcker, 1999), and were not able to absorb such flows easily. They led to large foreign exchange reserve increases, thus undermining monetary control and bidding up the one set of prices that could move relatively easily—domestic asset prices—with self-reinforcing "bubble" effects on economic activity and the incentive for additional inflows. Concern had been raised in places such as the 1995 Executive Meeting of East Asian and Pacific central bank governors, and in the IMF's own research papers.[8]

Perhaps Mexico, with its abundant funding, made the problem look less intractable (Blustein, 2001: 11). Maybe, also, the IMF had to trim the estimates of required support to fit the available funds (hence the emphasis on the ephemeral "second-line" contributions, so that the policy was almost invariably described, in public discussion, as a $43 billion support package, rather than as the $18 billion of support from the international financial institutions). And of course it has to be said that no one else predicted the extent of the outflow. (Some close to the market saw that the exit would be swift and total, but were too busy adjusting their own exposures to offer policy advice.) Whatever the reason, this seems the critical misassessment, from which other faulty judgments flowed.

It might be noted, also, that the IMF was inhibited in exploring more radical ways of addressing the capital reversal—what are grouped under the pejorative term "capital controls" (Fischer, 2001: 63). The point can be made succinctly by recalling that, in the early months of the crisis, the IMF was still lobbying hard to include capital account liberalization as its mandate (in the same way as current account liberalization). This proposal was pursued as recently as the IMF/World Bank Annual Meeting in Hong Kong SAR in September 1997—as the crisis was unfolding. It was a difficult time to acknowledge the dangers of excessive flows, and to contemplate restriction of inflows as part of crisis prevention would have been tantamount to heresy. If it was heresy to suggest that financial markets were not distributing world capital in a rational and stable way, then it was a mortal sin to contemplate restriction of outflows (bailing in the private sector) as a response to the unfolding crisis. This possibility was raised in August 1997 in relation to the Thai crisis, but had been categorically rejected.[9] (It later became part of the IMF's tool kit, but too late to help in the

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[8] Some have suggested that the size of the foreign borrowing was not known to markets. While the full extent of the borrowing was not known with precision, its broad scale and short-term nature were (see, for example, Radelet, 1995).

[9] It is now said by the IMF that Japanese banks agreed to remain in place in Thailand (Boorman *et al*., 2000), but the Thai assistance meeting chaired by the IMF's Deputy Managing Director in August 1997 refrained from discussing this topic. In the event, outflows equal to 12 percent of GDP in 1998 do not suggest that any behind-the-scenes deal was effective.

resolution of the crisis.) The G10/IMF mindset of the time restricted the range of responses, with strong commercially driven opposition to any bailing-in process. [10]

IV. Policy Response to the Unfolding Events

The initial strategy can be seen in terms of two elements—"restoring confidence;" and supporting the exchange rate through higher interest rates and intervention in the foreign exchange market.

A. Confidence

To the extent that the problem was seen as analogous to a bank run, confidence was clearly the central issue, and was addressed principally via structural conditionality—requiring Indonesia to make difficult reforms as a demonstration of the country's commitment to good governance.[11] But there was an intrinsic problem. While measures to combat corruption might find favor with new investors, this group would not respond immediately. Meanwhile existing investors who previously had worked out some *modus vivendi* with the system would feel threatened rather than reassured. In any case, these structural factors were longstanding problems (corruption, maladministration, weak prudential supervision, seriously deficient governance in both public and private sectors, and inadequate accounting and bankruptcy laws). Realistically, these could not be solved quickly enough to satisfy those investors who now, belatedly, saw them as important problems.

The structural part of the IMF-supported program got away to a bad start. The first and most dramatic manifestation of Indonesia's first Letter of Intent (LOI) to the IMF was the closure of 16 small banks at the beginning of November. It was done with no general guarantee in place for depositors, and even the newly instituted limited guarantee applied only to relatively small depositors at the closed banks, so was no help in limiting runs on banks that remained open.[12]

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[10] The G10 group comprises 11 industrialized nations: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

[11] In practice the more important factor might have been the desire to make use of the opportunity of the crisis to push through long desired reforms (IEO, 2003: 42; Djiwandono, 2001a: 5).

[12] For discussion of the closures, see McLeod (1998) and Cole and Slade (1998). On the merits of a bank guarantee, see IEO (2003: 40, 76), and Enoch *et al.* (2003: 84–6). It is worth noting that bank closures were not made in the early stages of the crises in Thailand and Korea, and when they were, it was only with full deposit guarantees in place.

We noted above that the “usual suspects” routinely blamed for the crisis—overly tight money and fiscal policy, and overly demanding structural conditions—cannot, in themselves, have been responsible for its extent. But with each of these issues, the heated and very public arguments for tighter policies and effective conditionality unnerved financial markets. The interaction between the IMF and the Indonesian government quickly degenerated to the stage where the market perceived the program to be under threat, and this was fatal for market confidence:

> The market watches carefully a country’s relations with the Fund, how the country’s economic policies are perceived by the Fund, and whether the country is adhering to, or sliding back from, the agenda that was committed to when it came into an agreement with the Fund (Kartasasmita, 2001: 21).

Disputes about interest rates, fiscal policy, and structural conditionality not only unnerved markets, but so dominated communications between the two parties that the critical problems created by the fast-changing environment could not be properly handled.

There are many examples of the ongoing friction between the IMF and the Indonesian authorities, but the events surrounding the first January budget, early in 1998, will illustrate the point. This budget had been prepared at a time of rapid exchange rate depreciation and when overly optimistic growth forecasts were still prevalent (Kenward, 2002: 57–8). The market saw the underlying assumptions as too optimistic, and interpreted the budget bottom line as breaking program conditionality. Press reporting of the budget included earlier critical public comments by an IMF official, quoted verbatim. The impression that the market took from all this was that the IMF-supported program was in serious jeopardy (the IMF comments clearly implied as much), and market players reacted by pushing the exchange rate down 25 percent in a single day.[13] This took the currency, for the first time, clearly beyond the levels of depreciation experienced elsewhere in Asia. In rupiah terms, foreign debts were now four times their precrisis level.

What was needed was some notion of “triage”—sorting out what needed to be done urgently and what could be put on a slower track. According to Boediono (who was closely involved in policy at the time):

> The implementation of the [IMF-supported] program during the Soeharto era was … characterized by rapidly weakening ownership. This process was triggered by the president’s disenchantment with the program’s early performance. His disaffection deepened as he increasingly felt pressured to accept conditionality, which was repugnant to him. We can only speculate with respect to counter-factual scenarios. But it is quite possible that things might have turned out differently had the conditionality (particularly in the first two LOIs) been confined to issues that were

[13] An alternative view of this episode is offered by Fischer (2001: footnote 24).

> really critical to handling the emerging crisis (which certainly would have included comprehensive banking reform). Other issues that were not critical (such as the dismantling of the clove monopoly, IPTN, and the national car project) could have been postponed until our heads were above water (Boediono, 2002: 386–7).

There was a need, too, for some realism about just how quickly institutional reform could take place. What happened instead was twofold: there was a constant drum-beat of disputation between the IMF and the authorities, and the conditionality was increased so that it became more likely (rather than less) that Indonesia would not be able to meet the terms of the LOI.

As the problems developed, the rationale for structural conditionality changed, and the confidence-building objectives were lost in the process. The first (October 1997) LOI had built on the structural reforms contained in Indonesia's own September package.[14] The context here was that the crisis was seen as an opportunity for the economic team to achieve some long desired structural measures, rolling back creeping protectionism and special relationships. There were some politically difficult elements in the October conditionality: the elimination of petroleum subsidies (always a politically charged issue) by March 1998[15] and the *de facto* ending of the national car project. But the October measures clearly had the support of the Indonesian economic team, no doubt because they, too, saw this as an opportunity for reform. In the mid January 1998 negotiations, the nature of the conditionality changed fundamentally. It was driven largely by the United States (Blustein, 2001: Chapter 8), and came to be perceived by financial markets as an assault on the position of the First Family and their closest cronies—a "take-it-or-leave-it" negotiation, a public arm-wrestle, with detailed requirements for comprehensive dismantling of monopolistic relationships, combined with ambitious timetables for doing away with these and fixing Indonesia's longstanding institutional inadequacies.[16] The effect was to create a series of hurdles that the Indonesians could jump only with great difficulty, and any stumbles would be seen by financial markets as possible triggers for a withdrawal of the program.[17] It is difficult to imagine how any of this could be seen as part of a program to raise confidence.[18]

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[14] For a discussion of conditionality, see McLeod (1998).

[15] This was the trigger for the downfall of Suharto, and has proven just as difficult in the post-Suharto era.

[16] Symbolic in this respect was the posture of the IMF Managing Director as he was photographed standing, with arms folded, while the President of Indonesia signed the LOI in January 1998.

[17] The "crony cabinet" appointed in March 1998, remarkably and unexpectedly, managed to jump many of these hurdles, but even where there was success—for example in the

(continued…)

B. Interest Rates and Intervention

There is a rich (or at least extensive) literature on whether higher interest rates can restore a falling exchange rate.[19] The crucial question was: "how high?" If the rationale had been based on portfolio analysis, the aim would have been to offer rupiah depositors an interest rate high enough to compensate them for the likely depreciation in the rupiah. The problem was that such an interest rate would be very high indeed. If the best guess was for a 1 percent depreciation over the next day (and on many days the outcome was considerably worse than that), then the annualized rate would have to be more than 1,500 percent. If this seems absurd, it is worth recalling that rates of over 500 percent were reached during the (ultimately unsuccessful) defense of the Swedish krona in 1992. As far as can be seen now, no one was advocating these sorts of rates; the IMF seems to have accepted that the rates of around 30 percent reached in the first stage of the crisis, in August 1997, were already tight, and that the level of Bank Indonesia certificate (SBI) rates at the start of the program—20 percent—was about right.

As the crisis unfolded, demands for higher interest rates became more strident: the logic seems to have been that, as long as the exchange rate was falling, interest rates were too low. The historical experience suggests that sometimes the interest rate defense works and just as often it does not. It is possible to go a little further and say that, where the financial sector is simultaneously in trouble, both the historical experience and intuition would suggest that the chances of this strategy doing the job are small (Goldfajn and Gupta, 1998). There is no need to take this further and argue, as Furman and Stiglitz (1998) have, that the higher interest rates damaged the banking system and hence economic activity, thus increasing the capital outflow and exacerbating the downward pressure on the currency. In the case of Indonesia, raising interest rates to attract new capital to replace the fleeing money was like offering a discount on tickets to a theatre already ablaze, with the patrons streaming out.

As far as intervention goes, the Australian experience, for example, shows that intervention has been successful in the specific sense that it has been clearly very profitable over the course of the exchange rate cycle. Whether it changed the path of the exchange rate significantly is another (unanswerable) question. Even extensive intervention does not pay off quickly: the profits come from the ability of the central bank to last out the exchange rate cycle and reverse its transactions, routinely three to five years later. In the process, something

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elimination of the much derided clove market monopoly—the political capital used up in these victories was not available for the central issues, such as bank restructuring.

[18] Former U.S. Federal Reserve chairman Paul Volcker captured the nature of the problem during a visit to Indonesia early in January 1998, when he described the policies as more a "cooking program" than an economic one.

[19] For the debate within the IMF, see IEO (2003: 68).

has been done to "lop the peaks and fill the troughs," but no one is claiming too much. There is no evidence that intervention in the face of a strongly held view by the market has a high probability of success.

V. What Should Have Been Done?

A realistic approach for Indonesia in October 1997 ("Plan A") would have been to try the combination of higher interest rates and foreign exchange intervention, but with the understanding that the chances of this working would be less (probably far less) than 50:50. Give it a go, briefly, but get "Plan B" ready.

The measure of success for Plan A would be whether it could confine the fall in the currency so as to avoid a systemic crisis in the banking sector. How big a fall in the exchange rate could be tolerated? Given the vulnerability of the banks to the derived credit risk from the corporate sector's foreign exchange borrowings, a sustained fall of only 25–30 percent would have left the banks in very deep trouble. If foreign direct borrowing by companies was around $80 billion, then at the precrisis exchange rate this amounted to around half the size of their borrowings from the domestic banking system. If the exchange rate fell only 25 percent, this debt rose by one-third in rupiah terms and, combined with the foreign exchange debt from the domestic banks (around 20 percent of lending by domestic banks), the impact of this on a system already acknowledged to be carrying a dangerously high level of bad and doubtful debt would be fatal, not just for the companies that had borrowed, but for the Indonesian banks that were their principal creditors.

Aiming to hold the exchange rate to a 25 percent fall seems optimistic. In Australia and New Zealand, falls of 25 percent over the course of a normal terms-of-trade cycle are routine, even without significant capital outflows. Countries that have been subject to once-off attacks on their exchange rate have experienced much larger shifts—the pound sterling in 1992 and the Swedish krona in the same year—and these overshoots have been sustained for years rather than weeks. These are countries with a considerable history of floating exchange rates, where financial markets have breadth, depth, and resilience, and market expectations are reasonably well anchored by historical experience. Once the rate was unanchored in Indonesia, it would have been sensible to anticipate larger and prolonged shifts in a country with little or no experience of floating.[20] Hence it was very likely that a Plan B would be needed. The two principal additional elements of Plan B would have involved the capital outflow and the banking sector.

A. Capital Flows

The problem of capital reversal may have been more amenable to treatment than was thought at the time. While many foreign creditors would have wanted quick repayment, they were not

[20] Indonesia had floated briefly in the 1960s, under very different circumstances.

all in a position to enforce this. To the extent that the inflow represented direct borrowing by Indonesian corporations, there could be (and was) substantial *de facto* default. This would hardly be an ideal solution, nor one that the policy makers could advocate as their definitive answer to the problem, but it was one the foreign lenders—for all their indignation and invocations of the sanctity of contract—would have understood. After all, why were they being paid substantial risk premia if there was no risk?

This idea—that the reversal might be limited by the borrowers' inability to pay—did not have much encouragement. In fact, in early 1998, the IMF explored arrangements under the general rubric of "Ficorca"—the Mexican response to its crisis of two decades earlier, in which foreign loan repayments had been given a guaranteed favorable exchange rate to facilitate payment. Rather than raising such hopes among creditors, it might have been better if the authorities had advised creditors, instead, to pursue debt rescheduling and debt for equity swaps—and had facilitated these with administrative measures. These financing contracts were between "consenting adults": when something goes wrong, it is up to the two parties to sort it out without pressuring their own governments to use the full force of the government-to-government relationship to try to obtain repayment. Foreigners had made contracts with Indonesians in the knowledge that these would be unenforceable in Indonesian courts, and they should have been left with the consequences of their actions. Instead, the cacophony of foreign creditors reminding the IMF of the sanctity of loan contracts may have prevented some clear thinking on the nature of this outflow.

The one substantial leakage that needed to be addressed urgently was the commercial banks' foreign borrowings. In Korea these were the largest component of foreign debt, and the IMF (and the United States) brought the parties to a swift rollover agreement temporarily halting debt service, and then to rescheduling. It was often observed that Indonesia was different: bank debt accounted for only around one-quarter of foreign private debt. If this had been subject to a rollover and the bulk of the direct borrowings had been rescheduled, the capital outflow might well have been manageable, but instead of a rollover being coordinated, the outflow was facilitated. Indonesian banks could draw more or less freely on rupiah liquidity, and with an open and free foreign exchange market, this could readily be converted into foreign exchange. As a result, the bank-to-bank borrowings were largely repaid before the agreement was reached in August 1998 (one year late) to roll over the residual.

So much for the capital reversal driven by foreign debt repayment. What of outflows of Indonesian money? Despite stories that every *becak* driver had sent his money to Singapore, there is no evidence in the figures of substantial outflows.[21] Rupiah deposits stayed more or less unchanged, then rose, during the crisis. What probably did occur is significant capital movements by ethnic Chinese businesses, but anecdotal evidence dates this from January 1998 or later, when street rioting threatened the personal security of ethnic Chinese families.

[21] Fischer (2001: 25) attributes much of the problem to domestic outflows, but without providing the data.

The failure to restructure the banking system also exacerbated the capital outflow. If banks could not be closed, Bank Indonesia (BI) had little choice but to provide liquidity support for those that were failing to meet their cheque-clearing payments system needs and reserve requirements. But support did not have to be the blank cheque that appears to have been given: there seems to have been a lack of oversight of the balance sheets of the banks being supported, and it is very likely that the banks misused a significant volume of this refinance support to fund not only the repayment of their own foreign debt, but general capital outflow as well. In addition, banks that found themselves with excess liquidity in this chaotic period probably used some of it to fund outflows (McLeod, 2003). If they could not do this in their own name, they could make loans to "insiders" who were not constrained by prudentially imposed open-position limits. If this interpretation is correct, then the sort of Plan B outlined here, involving orderly bank restructuring (which would have seen many bank closures) combined with vigorous SBI sales to mop up excess bank liquidity, would have prevented this downward pressure on the exchange rate.

B. Bank Restructuring

Realistically, even with the BI liquidity support tap turned off, there is nothing in this strategy that would have prevented a significant fall in the currency—and, indeed, part of the strategy suggested here (the *de facto* default on private foreign debt) depended on it. So the policy problem that needed to be addressed was the collapse of the banking system—the inevitable consequence of positive real interest rates and a depreciated exchange rate.

With hindsight, some people have come to the view that the banking deregulation reforms of October 1988 had been too fast and too sweeping, and had resulted in a proliferation of weak banks, often merely fund-gathering vehicles for conglomerates.[22] It was widely recognized that prudential supervision was inadequate—and the dismissal of the head of BI supervision in 1993 was an obvious sign of the malevolent power of vested interests. The Bank Summa failure in 1992 had also created a strong presumption that banks could not be closed without serious repercussions. Nonetheless, it was recognized that the creation of an effective prudential supervisory framework would take time and that significant progress had been made. Whatever the differences of view about the health of the banking system prior to the crisis (Enoch *et al.,* 2003: 76), most observers would have agreed that it was fragile, and that sustained high interest rates and a significantly depreciated exchange rate would result in systemic crisis. In the absence of any plan to restructure the collapsing banking system, the central bank had little choice but to prop it up with liquidity support, which allowed the problems to persist and worsen.

Some problems pre-dated the IMF's arrival on the scene, and even pre-dated the significant fall in the currency. In August 1997, at the time of the exchange rate float, the Indonesian authorities repeated the technique of the "Sumarlin shocks" of the previous decade, in which

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[22] For some discussion of this period, see Cole and Slade (1998) and Fane (1998).

state enterprises were required to use their bank deposits to buy SBIs (Kenward, 2002: 29–31; McLeod, 1998: 38–9). From the viewpoint of liquidity management, this is the same as an open market contraction of base money. Base money fell by 20 percent in the month, and the system was left so short of liquidity that many of the banks were failing to meet their cheque-clearing requirements at the daily payments settlements, or falling short of their required reserve levels: one quarter of the banks could not meet their reserve requirements at the end of August (Djiwandono, 2001b: 62). In a normal banking system, either of these events would have forced the central bank immediately to close the banks concerned, or to provide them with emergency liquidity.

The substantial foreign exchange interventions of the last two months of 1997, designed to prop up the rupiah, led to a further withdrawal of liquidity. At the same time, following the closure of 16 banks at the beginning of November, depositors shifted their funds from private banks to the state and foreign banks. So there was, simultaneously, a shortage of liquidity and a skewed distribution of what liquidity there was. In these circumstances, BI certainly should have made more effort to soak up any surplus liquidity in individual banks by selling SBIs to them. Nevertheless, banks could argue that, as the Monetary Board (the Finance Minister, the Coordinating Minister for the Economy and Finance, the Minister for Industry and Trade and the Governor of BI) had created the overall liquidity shortage, it should fix it (by lending to them). But BI could not tell which banks were illiquid and which were insolvent (within a short space of time, the overwhelming majority were in the latter category, although they continued to report profits). Bank Indonesia, in the absence of any more comprehensive plan, and disconcerted by the consequences of the ill-managed closure of the first 16 banks, took the easy way out and provided liquidity—as far as can be seen, more or less on demand. This mish-mash of influences on liquidity almost certainly gave some banks enough liquidity to fund a significant foreign exchange outflow, while at the same time the purchase of foreign exchange from Bank Indonesia tightened liquidity and left other banks struggling to remain liquid.

The best response might have been to accept that this would be an opportunity (albeit a very expensive one) for a dramatic restructuring of the banking system, a job that needed doing even before the crisis. So the focus would have been twofold. First, to retain in operation those parts of the system that were vital to ongoing commerce. This might have been confined to the core payments system and foreign trade financing. A difficult and expensive decision was required on depositor protection, but a good case can be made that the long-term development of the financial system requires a core set of riskless institutions, and so bank depositors should have been protected. If this protection is less than complete, and does not operate smoothly, then the banking system will always be vulnerable to runs. Leaving to one side the details of any such restructuring, Plan B would result in fewer (in fact, few) banks still operating and in depositors being protected to a greater or lesser degree. This would have been expensive, but far less expensive than the actual outcome (no bank owners would have been bailed out, no capital outflows would have been financed, and no new loans would have been given by zombie banks). It might at least have been a significant step toward a restructured banking system. Despite capital injections amounting to 60 percent of

GDP, the Indonesian banking system is still weak and has 10 times as many banks as Malaysia.[23]

C. Interest Rates and Intervention

Having explored these two additional elements needed to make up an effective "Plan B," it is worth returning for a moment to the issues of interest rates and intervention. How should these have been adjusted to suit this more comprehensive strategy?

First, on intervention. Significant currency market intervention (probably around $10 billion from Indonesian foreign exchange reserves, plus intervention by Singapore and Japan) took place in the period following the first LOI, with the general objective of holding the rate in the range of Rp 3,000–3,500 to the U.S. dollar. As suggested above, it would have been a surprising outcome if the rate had been held to a depreciation of only 25–30 percent. Even Singapore, in far better shape on all fronts, allowed its exchange rate to fall by around 25 percent before instituting a vigorous (and successful) defense. The path of the currency closely tracked those of the other countries involved in the crisis until early in 1998, suggesting that this degree of depreciation (amounting to around 50 percent) was not abnormal for the circumstances. While intervention was an appropriate element of the response to the crisis, the ammunition was fired off too early (or at too high an exchange rate).

One proposal, made by the central bank in February 1998, was to return to an exchange rate band, with the lower end set at Rp 10,000 to the dollar, and to use interest rates vigorously to maintain this, backed by intervention. This has to be put in the category of "hypothetical." But it had a greater chance of working than the actual strategy. Whether the president would have allowed interest rates to rise is one of the hypothetical elements in this alternative strategy. But at least this would have put the trade-off in bold relief.[24]

Here is an example where a policy dialogue, rather than a generalized harangue by one side, might have been more fruitful. Interest rates are a sensitive issue in any country. After the hike to 30 percent in August 1997, there seems to have been a general acceptance that this represented overly tight policy, and that rates would quickly fall. The main pressure for lower rates came from businesses that had borrowed. There was no urgent need to raise lending

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[23] For some discussion of the current banking system and what might be done to restructure it, see Grenville (2003).

[24] Another possibility that might have been worth considering was to introduce a dual exchange rate, making foreign exchange available at a realistically fixed exchange rate for imports of goods and non-debt services. Other foreign exchange needs would have had to be met in the open market. While there would have been a lot of leakage from any such dual rate system, it would have reinforced inhibitions on capital transactions and further encouraged foreign creditors to strike a deal.

interest rates, as a high rate was not needed to inhibit new lending—for credit-risk reasons, very little new lending was being done other than "directed" lending (which needed to be addressed as such).[25] Reasonably high deposit interest rates were needed, but there are no signs that the actual rates of interest were inadequate to retain deposits. Where higher rates were needed was in SBIs—Bank Indonesia's open-market instrument. As noted above, it seems probable that banks with surplus liquidity used the opportunity to buy foreign exchange, and this downward pressure on the exchange rate could have been alleviated by offering them a good return on a safe rupiah instrument. If the president could not be persuaded to allow formal rates to rise, a higher return could have been offered in the form of a discount instrument (with the implicit interest rate hidden in the price), which the banks would have understood but which would have gone under the president's vision. So the real problem here was the absence of an operational dialogue between the policy makers, to identify the constraint on good policy making and find a way around it.

At the same time, the formal target for monetary policy, embodied in the LOI, was base money. This was a technically inappropriate objective.[26] Even under stable conditions, base money targeting has long been abandoned by all OECD central banks. The case against base money is much stronger in the unusual circumstances of a crisis, as there is no hope at all of setting an appropriate target in a world where the demand for the main component of base money—cash—is shifting rapidly, and this demand has to be met. As has been noted above, the problem was not that this led to inappropriately high interest rates—the contrary occurred for much of the critical first six months of the crisis.

D. Communication

Quite early in the program, President Suharto lost confidence in his economic advisers. This is clearer in retrospect than it was at the time, but the "second generation" economic team did not have the confidence of the president, even before events turned against Indonesia (Kenward, 2002: 40; Boediono, 2002: 386). The ill-managed closure of the 16 banks at the beginning of November certainly undermined what confidence there was.[27] Business people were saying (not without justification) that they could not sustain the higher interest rates. By the end of November it was becoming clearer that the rupiah would not be restored to anything like its initial level, and in fact was continuing to fall. It is unsurprising that the president lost faith in his advisers around this time, especially as they had nothing to offer

[25] The level of outstanding credit continued to rise quickly in part because accrued interest was capitalized.

[26] For a debate on this issue, see Greenville (2000a, 2000b) and Fane (2000).

[27] Three BI managing directors were dismissed on the president's orders at the end of 1997, and the BI governor in February 1998. As well, the head of the economic team was out of action because of ill health for some of the critical period.

other than "try harder with the existing strategy."[28] This became painfully obvious in mid January 1998, when the president decided to negotiate with the IMF himself, excluding the economic advisers from the crucial meetings. The opportunity for getting the program back on the rails in the last part of 1997 was, in any case, made more difficult by the president's health scare early in December, which focused financial markets more than ever on the political dimension of the crisis, revolving around succession.

Whether the IMF could have performed better in this process of communication is a moot point: the principal problems were clearly between the president and his Indonesian advisers. But the IMF's *modus operandi* did not put it in a good position to help. Missions came and went, with two separate teams alternating, and frequent "protocol" visits from IMF officials at the highest level. What was needed was sustained and continuing dialogue, with a single IMF team permanently on the ground that had sufficient delegated authority to formulate proposals and negotiate them in real time. Increasingly, IMF staff on the ground felt the need to refer issues back to Washington, with greater involvement of Executive Board members as the program faltered. The IMF's own governance system, with its detailed discussions of policy and day-by-day developments taking place at Executive Board level, seems particularly ill suited to this kind of policy making.[29] Executive Board members rarely have the benefit of local knowledge, and the subtleties and nuances that go into national economic policy making are generally absent from Board discussions.

What was needed was for the IMF team to establish an ongoing presence on the ground that had sufficient seniority and delegated authority to carry on substantive negotiations and policy discussions. This "plenipotentiary" team would obviously have needed briefing and instruction from Washington, but would have been able to operate more flexibly and effectively. The concentration of negotiations at the highest level (the Managing Director or his senior deputy) meant that meetings were always running to a tight timetable and were high profile, with the market on tenterhooks about whether agreement would be reached. Effective policy making might have been assisted by moving it out of the spotlight and making policy dialogue a continuous process, able to respond quickly to new opportunities and to maintain steady pressure, rather than a high-profile confrontational negotiation.

[28] One widely accepted policy making adage is: "You can't beat something with nothing." When alternatives such as the totally inappropriate currency board proposal came up in early 1998 (McLeod, 2000: 23), there was no policy alternative offered other than "more of the same."

[29] For a description of these discussions (particularly the role of the U.S. Executive Director) see Blustein (2001: 101, 114, and 156).

VI. Conclusion

The initial question posed by this paper was: "Did the IMF offer the best advice?" The argument made here is that it did not. The problems might be seen at three levels: technical, in the overall appreciation of the nature of the problems, and in the way policy advice was developed and delivered.

The initial key technical error occurred before the IMF arrived: the sharp cut in base money in August 1997. This left the financial system with a critical shortage of liquidity and set the scene for the central bank liquidity support blowout, as Bank Indonesia grappled with the resulting disorder. It is surprising that the IMF, when it arrived on the scene, did not identify the error with base money, which would have led it to the liquidity support problem[30] and would have highlighted the problems in the financial sector: after all, base money and the financial sector health are the IMF's area of core competence.

But the crisis was not just a matter of technical errors. Probably more serious was the mis-assessment of the nature of the capital flows (both the inflows before the crisis, and the outflows after). Large outflows were inevitable, and the debilitating fall in the exchange rate, the dramatic fall in GDP and the collapse of the financial sector followed quite directly from this.

Whether there was a mix of policies that could have avoided serious damage to the economy is debatable—and unknowable. But if there was to be a chance of containing the situation, policy had to be responsive and open-minded. The effective policy adviser develops options that can be "sold," and when elements of policy are not working well, they are modified. The first priority is to retain the ear of those being advised. The IMF's *modus operandi* does not have this nimble-footed responsiveness. It starts with precedents (many of which have come out of Latin American experience), involves short visits with tight predetermined timetables, and has to be responsive to detailed and often ill-informed policy interventions from around the board table in Washington. Many of the lessons of the Indonesian experience have been taken aboard by the IMF (as in the Brazilian program), but this learning process came too late to halt the rapid deterioration in Indonesia.

Finally, of course, the economic events were being played out in the context of a political crisis, itself catalyzed by the economic crisis, under which good economic policy may have been simply infeasible.

[30] IEO (2003: 72) suggests that the IMF did not know about this until early in 1998.

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