PRELIMINARY

The Causes and Consequences of Indonesia's Economic Crisis

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The Chronology of the Crisis

> *"If anyone had predicted a year ago that Indonesia, South Korea and Thailand would have to go cap in hand to the IMF, they would have been thought mad" ("East Asian Economies Survey",* ***The Economist****, March 7, 1998, p. 5).*

To many people, both in the region and elsewhere, the crisis which struck South East Asia in the latter part of 1997 seemed like a bolt from the blue, a meteor crashing from outer space onto what had seemed to many experts to be one of the most dynamic and successful parts of the world economy. How could a group of economies whose performance the World Bank considered "miraculous" go into such rapid and catastrophic decline? In 1996 the World Bank confidently predicted that:

> Although looking into the future is always a risky business, some things are likely to be good bets. Rapid growth is likely to continue in East Asia, and the pace of change experienced by these economies should continue to be very impressive. East Asian economies are committed to an open and cooperative approach in the evolution of economic relations among themselves and with the rest of the world, and will use market-based and competitive means to achieve their goals[1].

But in fact by the latter part of 1996, this type of buoyant optimism was already tempered with a growing concern about economic trends in several parts of the region. In what turned out to be a startlingly prescient article, the **Economist** of August 24, 1996 drew parallels between the Mexican economy in the run up to the crisis of late 1994, and emerging trends in Thailand, Malaysia, Indonesia and the Philippines[2]. One obvious similarity was the large balance of payments deficits as a percentage of GDP in both Malaysia (9.7 per

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[1]**Managing Capital Flows in East Asia** (Washington :World Bank, 1996), p. 126

[2]**The Economist**, August 24, 1996, pp. 67-8

cent) and Thailand (7.7 per cent), compared with 7.8 per cent in Mexico in 1994. Although the deficit was larger in Malaysia as a percentage of GDP than in Thailand, a much higher proportion was funded by long-term inflow of foreign direct investment. In Thailand by contrast the balance of payments deficit net of FDI inflows was still very large in 1996; at 7.5 per cent of GDP it was higher than in Mexico two years earlier. In other words almost all of the large balance of payments deficit in Thailand was funded by short-term capital inflows.

Several other worrying trends had emerged in Thailand by the end of 1996[3]. After over a decade of very rapid export growth, in 1996 commodity export earnings hardly grew at all, and earnings growth from invisibles such as tourism also slowed. There were several reasons for the slowdown; one was the appreciation of the baht against other regional currencies induced by the policy of pegging the baht to the US dollar. Another was the sharp increase in real wages which had occurred since the early 1990s. This together with a severe shortage of skilled and semi-skilled workers, due in turn to government negelct of the post-primary education system, induced many manufacturers to re-locate their plants to other parts of the region where labour was cheaper (such as China, Vietnam or Bangladesh) or where skilled workers were more readily available (Hong Kong, Singapore or Malaysia). There was also concern about over-supply in the commercial and residential property market, especially in Bangkok. More broadly it was felt that the era of rapid growth was coming to an end and that the economy faced an uncertain future; a *Financial Times* survey summed up the situation at the end of 1996 as follows:

> Over the past year, it has become painfully obvious that Thailand can no longer produce the growth rates to which it has become accustomed; an average of 8 per cent a year for 10 straight years, on the back of government monopolies, asset inflation, cheap labour, tariff protection and illegal activities.

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[3] Warr, **Southeast Asian Affairs,** 1997; **Financial Times Survey: Thailand,** Thursday December 5, 1996. See also Jayati Ghosh, Abhijit Sen and C.P. Chandrasekhar, "South-East Asian Economies: Miracle or Meltdown?", **Economic and Political Weekly,** October 12-19, 1996, pp. 276-2780

In other parts of the region, there appeared to be less cause for concern, at least on the economic front. After a long period of economic stagnation the Philippines economy had begun to recover during the Ramos administration, while in both Indonesia and Malaysia the economic boom which had begun in the latter part of the 1980s showed no signs of slowing down. Although the political situation in Indonesia was giving cause for concern by early 1997, with a number of anti-Chinese and anti-Christian riots in various parts of Java and serious disturbances in West Kalimantan, there was still considerable confidence in the strength of the Indonesian economy. Jay Solomons, writing in the *Far Eastern Economic Review* in February 1997, argued that sound economic fundamentals meant that the Indonesian economy continued to grow at a solid pace in spite of the political storm-clouds[4]. He stressed the strong economic growth in 1996 (GDP growing by almost eight per cent), a "manageable balance of payments deficit of around four per cent of GDP", declining inflation (6.5 per cent per annum in 1996), strong investor confidence, symbolised by high levels of inward foreign investment, and an apparent determination on the part of President Soeharto to limit the growth of government expenditure. All these economic signals, according to Solomons, "have set investors alight".

Solomons's views were widely shared in the Asian region, and as Thailand's problems became more obvious and more widely discussed in mid-1997, there appeared to be widespread agreement that "Thailand's maladies are painful, but probably not contagious"[5]. But at the same time, several commentators stressed that there were lessons to be learnt from Thailand's plight. Underinvestment in public infrastructure and education together with the appreciation of the baht against most other Asian currencies were the obvious reasons for the export slowdown. The liberalisation of the capital account of the balance of payments in the early 1990s, and especially the launching of the Bangkok International Banking Facility in 1992, were expected by the government to turn Bangkok into a dynamic regional financial centre to rival Singapore and Hong Kong; in fact these policies induced many Thai businesses and financial institutions to borrow abroad in dollars or yen at lower rates of interest. The risk was perceived to be minimal because of the policy of keeping the baht tightly pegged to the dollar. Although part of the

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[4]Jay Solomons, "What Political Risk?", **Far Eastern Economic Review,** February 20, 1997, p. 56.
[5]"Let This be a Lesson", **Far Eastern Economic Review**, June 12, 1997, p. 71.

foreign borrowing went into investment in export-oriented manufacturing industry, a considerable share went into sectors producing non-traded goods, especially real estate. Even that investment which went into the industrial sector was often used to expand capacity in sectors such as steel and petro-chemicals were both domestic and international markets were becoming glutted.

On July 2, the Thai government was forced to bow to the inevitable and allow the baht to float; it rapidly dropped from 26 to the dollar to 32 to the dollar by early August and 35 to the dollar by early September (Figure 1). Pressure on other currencies in the region intensified; to many observers indeed it was inevitable that "every currency in the region needs to weaken" to restore the parity with the baht "and deny Thai exports the advantage of a currency suddenly 20% cheaper"[6]. In fact at the end of July 1997, the Indonesian rupiah looked to be in a stronger position than most other currencies in ASEAN. Bank Indonesia decided to widen the band in which the rupiah could trade from 8 to 12 per cent. Traders were quoted as saying that such a wide band made the rupiah safe against concerted attacks by either foreign or domestic speculators.

During September 1997, analysts continued to express most concern about the Thai economy. The IMF had approved a standby credit package in August which was subsequently increased to $17.2 billion, to be disbursed on condition that the Thai government budgeted for a small surplus in 1998, and introduced structural reforms in the financial sector. But this assistance failed to stop the slide in the baht, which by the end of October had dropped to slightly over 40 to the US dollar. Public confidence in the government led by Chavalit Yongchaiyudh rapidly waned, and in early November he announced his resignation. The new government under Chuan Leepkai assumed control within the framework of the parliamentary process, a fact which gratified many Thais even if compromises had to be made in the choice of cabinet members. The baht had recovered to 37 to the dollar by mid-November[7]. To many Thais the dithering and prevarications of their government between early July and early November had been deeply disturbing, especially as the Indonesian reaction to the crisis had appeared to be so much firmer. But even as Thailand's economic management began to improve

[6]"Drop Everything", Far Eastern Economic Review, July 24, 1997, p. 83.
[7] Michael Vatikiotis, "High Hopes", **Far Eastern Economic Review**, November 20, 1997, p.24

under the Chuan government, the Indonesian economy began a rapid slide into chaos.

After the flotation of the baht, the Indonesian government won much praise in the international media and in international financial circles for its economic management. Indeed as in the 1980s in the wake of the sharp decline in world oil prices, bad times in Indonesia appeared to be making for good policies.

> Instead of squandering reserves of foreign exchange to defend its currency, the central bank gave up almost without a fight and allowed the rupiah to float. It swiftly followed this up with exemplary policy measures; higher interest rates, budget cuts and a pledge of more deregulation[8].

The problem was that investors and speculators while applauding this evidence of sound policy-making kept on selling rupiah; by early October the rupiah was trading at 3,600 to the dollar, compared with 2,500 in July. The World Bank's chief of mission in Jakarta was quoted as saying that "there is no economic reason for what is going on" but in fact the reason was quite plain. Many Indonesian companies had very substantial foreign short-term debts and as the rupiah fell and Bank Indonesia made it plain that there was to be no official intervention, they realised that they may not be able to continue servicing these debts[9]. Obviously the panic was most acute among firms producing non-traded goods, such as real estate, but many export-oriented companies whose rupiah earnings were increasing with the devaluation were also concerned to hedge their foreign borrowings if at all possible. The result was a sharp increase in demand for dollars while the supply from either official or private channels was drying up.

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[8]**Economist**, October 11, 1997, p. 132

[9]The size of private sector debt was thought to be "at least $55 billion" in October 1997; by early 1998 Radius Prawiro, a former Minister of Finance who was acting as a special adviser to the president admitted that Indonesia's total foreign debt was $133.3 billion of which $52.4 billion was government-guaranteed. The Bank of International Settlements (BIS) has estimated that in mid-1997, short term external debt amounted to 182 per cent of total foreign reserves, compared with 153 per cent in Thailand and 62 per cent in Malaysia. See BIS 68th Annual Report, p. 128.

But there were deeper problems in Indonesia which neither the government nor international development agencies seemed prepared to acknowledge. As the rupiah fell, it was becoming clear that the government was losing the confidence of its own business class. The Chinese were already jittery as a result of the disturbances in 1996/97; in addition it became clear in the closing months of 1997 that Soeharto was not prepared to implement economic reforms which threatened the interests of his family and close associates. The IMF assistance package which was announced at the end of October pledged $33 billion in assistance of which the IMF itself contributed $10 billion[10]. In return for this support, Indonesian technocrats led by the Minister of Finance, Mar'ie Muhammad, announced a number of reforms of both the financial sector, and the real economy including pledges to remove the trading monopolies of the State Logistics Agency (BULOG), and plans to remove local content rules on car production and lower tariffs on chemical and steel imports. Most of these policies were known to have been on the reform agenda of technocrats in the Ministry of Finance for some time, and most threatened the interests either of Soeharto's family or of his key business associates.

The most controversial aspect of the package was the closure of sixteen banks, several of which were owned by Soeharto family members. While it was not obvious that these banks were in any worse shape than many other Indonesian financial institutions, it appears that they were chosen at least in part because many were closely connected to the presidential entourage. Their closure provoked panic among many savers that they would not be able to retrieve their savings if other banks were to close. As will be pointed out below, these bank closures came in for special attention from critics of the IMF packages. Certainly the IMF package as a whole had only a very temporary positive impact on business confidence. Apart from concern about the health of the entire financial system, many Indonesians were openly sceptical that the other parts of the

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[10]See John McBeth, "Big is Best", **Far Eastern Economic Review,** November 13, 1997, pp. 68-9. Subsequently the package was increased to $43 billion dollars although this figure apparently included some Indonesian government funds. See Hadi Soesastro and M. Chatib Basri, "Survey of Recent Developments", **Bulletin of Indonesian Economic Studies**, Vol 34(1), April 1998. The veteran technocrat, Professor Widjojo Nitisastro was in charge of the first round of negotiations with the IMF.

programme would be implemented. Rumours also spread about the state of the President's health, especially after he returned from the APEC summit in Vancouver and immediately retired for "rest". He was thought to have suffered a mild stroke. By mid-December the rupiah had fallen to almost 5000 rupiah to the dollar.

As the international financial community lost confidence in Indonesian banks, both importing and exporting became more difficult. Indonesian letters of credit were no longer accepted abroad, and local banks became unwilling or unable to extend working capital even to their best clients. Foreign trade slowed alarmingly in the last part of 1997. The budget brought before parliament in early January 1998, appeared quite unrealistic in its assumpions about economic growth, the exchange rate and the rate of inflation. In mid-January, the IMF Managing Director, Michel Camdessus, came to Jakarta and negotiated a second and more far-reaching reform package with Soeharto, which included strong committments to removing cartels, and reducing expenditures on state enterprises. But almost as soon as he had left the country, Soeharto let it be known that he wished Dr Habibie, the controversial Minister of Technology, to be the next vice-president. The rupiah plunged to 17,000 to the dollar compared to 2,400 before the crisis began.

Over the next few weeks, in the run-up to the meeting of the Peoples' Consultative Assembly (MPR) in March which would re-elect him as President with Dr Habibie as his deputy, Soeharto made increasingly critical remarks about the IMF and the conditions it had imposed on him in return for financial assistance[11]. A business associate of his son invited Professor Steven Hanke of Johns Hopkins University to give advice on the establishment of a monetary board which would peg the rupiah to the dollar. The IMF and most international commentators considered such a scheme to be unworkable in Indonesia, bcause it would require foreign reserves equal in value to the entire stock of money including time deposits. By early March reserves were thought to be only one quarter of what would be necessary to make a currency board credible. Many commentators saw the currency board idea as simply a ploy by the

[11]He apparently told a group of Islamic parliamentarians that the IMF agreement which he himself had signed in January could not be implemented because it contravened article 33 of the 1945 constitution. Critics were quick to point out that this was the article which stated that the economy should be run along "family principles".

Soeharto familiy to enable them to get their own wealth holdings out of the country at a favourable exchange rate.

Once Soeharto was re-elected by a pliant MPR, with Habibie as vice-president, and had announced a cabinet packed with family and cronies, the IMF returned to Jakarta in April 1998 to negotiate conditions for further assistance. The IMF team claimed that they were prepared to be flexible in dealing with an administration many of whose members openly professed ideas quite contrary to IMF doctrines, and indeed to the spirit if not the letter of the previous IMF agreements. In early April a third IMF package was announced, involving increases in prices of electricity, fuel and transport and further curbs on budgetary expenditures. Soeharto immediately implemented most of the agreed price rises, thereby triggering further student protests. Campus unrest had already spread across the archipelago, and by early May mob violence erupted first in the North Sumatran town of Medan and then, after the shooting of four students at Trisakti University in Jakarta, in Jakarta, Solo and in other parts of Java. It appeared that elements wihin the armed forces under the control of Soeharto's son-in-law, General Prabowo, were responsible for the Trisakti shootings and for at least some of the subsequent attacks on Chinese premises in Jakarta.

After the terrifying mob violence and property damage which occurred on May 14-15 the intra-elite consensus which had supported Soeharto because all the alternatives appeared unacceptable, rapidly broke down. Key members of the Soeharto entourage began to distance themselves and some called openly for a change of regime. By the evening of 20 May, Habibie himself and most of the cabinet were advising Soeharto to stand down. The commander of the armed forces, General Wiranto guaranteed Soeharto that his family, their businesses and property would not be threatened. The next morning Soeharto resigned in favour of his vice-president. Although the resignation was greeted with jubliation on the streets, it was clear that it hardly amounted to a peoples' power revolution, but rather a reorganisation of power within the elite. This in turn was intended to pre-empt more radical attempts to change the nature of Indonesia's government. Habibie announced a cabinet shorn of Soeharto family and cronies but still retaining many members of the previous cabinet. Almost immediately critics began to call for new elections within a few months and a thorough enquiry into the magnitude of the Soeharto family's wealth. By the end of May few were predicting that Habibie would be more than a caretaker president. His own dilemma appeared to be acute. Should he try to be a Gorbachev and set in train changes to Indonesia's political and economic system which could well sweep him from office? Or should he try to restore confidence in the economy even if that meant putting off political change?

It is an indication of how much opinion in and about Indonesia has changed in the past year that now democratization is seen by many as a necessary condition for economic recovery, rather than as a threat to continued economic growth. Writing as late as 1994, one political scientist pointed out that in claiming that "democracy, growth, and unity in countries like Indonesia are probably in principle compatible", he was going against the "scholarly consensus to the contrary"[12]. But that scholarly consensus has now fragmented. While there may still be some, both in Indonesia and abroad, who would argue that such a huge and diverse nation can only be held together by some form of authoritarian government. many others now realise that it is only by widening the basis of popular support that regime legitimacy can be established, and that only a government with such legitmacy can push through the formidable agenda of economic and social reform that Indonesia needs in order to return to sustained economic growth. Most surprising of all, it appears that at least some in the armed forces now think along these lines.

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[12] "Can all Good Things go Together? Democracy, Growth and Unity in Post-Soeharto Indonesia" in R. William Liddle, **Leadership and Culture in Indonesian Politics,** Sydney : Allen and Unwin for the AASA Southeast Asia Publications Series, 1996.

Competing explantions for the crisis

Since the devaluation of the baht in early July 1997, financial journals around the world have been filled with comment from a wide variety of experts on the causes of what rapidly became known as the Asian crisis. A range of economists some affiliated to government bodies (such as the Council of Economic Advisers in the USA), some to well-known think-tanks (such as the Institute of International Economics in Washington), and some speaking as independent scholars also gave their opinions via the print media and the internet. International conferences and symposia proliferated. By mid-1998 the volume of expert comment was already enormous and showed little sign of abating. The views expressed by two very influential international organisations (the IMF and the BIS), and twelve well-known economists, journalists and politicians are set out in Box 1. These views are hardly exhaustive but they do give a fair conspectus of the stage which the international debate had reached in mid-1998.

It is obvious that there is much common ground between these various explanations for the Asian crisis. Most see the crisis as the result of easy global liquidity conditions and weaknesses in the domestic financial systems in the affected countries. All agree that "Latin American" fiscal recklessness, exemplified by large budget deficits, was not a problem in Asia in the 1990s. However among American commentators there is a clear difference between those who see the root cause of the crisis in weak institutions (leading to crony capitalism in all its manifestations) and those who view the crisis as the result of panic, which in turn was induced by inadequate or badly implemented international rescue packages. Broadly speaking, most Washington-based commentators fall in the first camp, while the main spokesman for the second camp is Professor Jeffrey Sachs and his colleagues at the Harvard Institute for International Development[13].

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[13]There are other supporters of these views; see for example Ross H. McLeod, "Some Comments on the Rupiah 'Crisis' ' in Hal Hill and Thee Kian Wie, **Indonesia's Technological Challenge,** Canberra and Singapore: Australian National University and Institute of Southeast Asian Studies, 1998.

The views of Prime Minister Mahathir are important because they reveal the sense of disillusionment, even betrayal, that many Asian politicians, civil servants, business people, academics and journalists feel about their treatment at the hands of global capital markets. Why did the markets turn so savagely against a group of economies who had been their darlings, praised by international development agencies, major financial institutions, the rating agencies and many other experts for doing practically everything right? True, there may have been policy mistakes, and some corruption in government decision-making, but surely these problems were not sufficiently serious to provoke the ferocious onslaught of late 1997 and early 1998. There must have been other malign forces at work, whose main aim was to destroy the "Asian miracle" and discredit the politicians who had done so much to bring it about.

Whatever the verdict of history will be on Prime Minister Mahathir, or indeed on the role of currency speculators, one trend emerged very clearly in the first part of 1998. Several eminent economists with impeccable scholarly credentials began to question the benefits for developing countries of unrestricted access to global capital markets. Indeed the idea that some "sand in the wheels" of international financial markets was needed to curb huge speculative movements in capital had been around at least since the late 1970s when Professor Tobin had suggested a tax on international financial transactions[14]. The currency crisis which erupted in Latin America and the Western Europe in the early 1990s all provoked further discussion of the costs and benefits of free and unregulated global capital markets. By early 1998 Professor Stiglitz was arguing that there may be a case for government interventions to control capital flows; he suggested that the Chilean imposition of a reserve requirement on all short-term capital inflows could be emulated in other parts of the world[15]. On the day the **Financial Times** carried Professor Stiglitz's article, the paper editorialised:

> The case for early and complete freedom for international capital flows has,

[14] For a recent overview of the issues, see in particular Barry Eichengreen, James Tobin and Charles Wyplosz, "Two Cases for Sand in the Wheels of International Finance", **Economic Journal**, Vol 105, pp. 162-72

[15] Joseph E. Stiglitz "Boats, planes and capital flows", **Financial Times,** Wednesday March 25, 1998.

> unquestionably, been damaged. The world's leaders must now ask themselves how to maximise the benefits of capital flows to developing countries, while minimising both the number of panics and the damage they do.

Many of the issues thrown up by this debate on the causes of the Asian crisis are amenable to empirical testing. By mid-1998, scholars were beginning to examine the evidence on causation, although perhaps not surprisingly, separating out the impact of institutional weaknesses from the impact of panic proved difficult. An analysis by two Korean economists came to the conclusion that

> both fundamental weaknesses and creditor panic were important factors in transmitting the effects of the Thai crisis to the other countries. The Thai financial turmoil first spread to other member states of ASEAN including Singapore, and then disrupted the financial and foreign exchange markets of Taiwan. The financial instability in Taiwan no dount contributed to the stock market plunge in Hong Kong, which sent shock waves to other stock markets throughout the world. It was only a matter of time before Korea would come under speculative attack, which it could not overcome. [16]

Thus the contagion from Thailand worked its way around East Asia. But this kind of analysis still leaves many questions unanswered, not least about the root causes of the problems in the worst affected economies of South East Asia. In the next section of the paper, I try to dig deeper into the underlying causes of the crisis in South East Asia, examining both internal and external causal mechanisms.

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16 Yung-chul Park and Chi-young Song, "The East Asian Financial Crisis: A Year Later", Paper prepared for the Conference on the Asian Crisis, Institute of Development Studies, University of Sussex, July 1998.

BOX Explanations for the Asian Crisis

(1)
"That this region might become embroiled in one of the worst financial crises in the post-war period was hardly ever considered - within or outside the region - a realistic possibility. What went wrong? Part of the answer seems to be that these countries became victims of their own success. This success has led domestic and foreign investors to underestimate the countries' economic weaknesses. It had also, partly because of the large-scale financial inflows that it encouraged, increased the demands on policies and institutions, especially but not only in the financial sector; and policies and institutions had not kept pace. The fundamental policy shortcomings and their ramifications were fully revealed only as the crisis deepened. Past success may also have contributed to a tendency by policymakers to deny the need for action when problems first became apparent (IMF **World Economic Outlook** May 1998, p. 3)

(2)
"A fragile financial sector, weak supervision and prudential regulation, and a corporate sector burdened with high levels of short-term debt were at the heart of a series of crises in Asia in the second half of 1997. In particular they greatly increased the complexity of managing in a sound and productive manner the foreign funds that surged into Asia in the mid-1990s" (BIS 68th Annual Report, p. 33)

(3)

It's been a crisis of microeconomics. This is not a crisis of budget deficits and wasteful government spending, which happened in Latin America, say, in the 1970s. This is a crisis really centered on the private sector, with different components. First, you had a tremendous amount of liquidity in the region in the 1990s. Second, you had a crisis in how capital was allocated in countries like Thailand, which does not have very good banking supervision...Third, in the case of Korea, the problem is government industrial policy. You've had policy-driven lending to finance a massive expansion of industrial capacity (David Hale, Zurich Group economist, **Fortune,** January 12, 1998, p. 10).

(4)
Tha main problem in East Asia was not macroeconomic, but structural. deep flaws afflicted the financial system. They include excessive leverage, and a banking system based excessively on directed lending, connected lending, and other collusive personal relationships. Ten years ago, finance experts called it relationship banking, and thought it might help to minimise "problems of asymmetric information and incentive incompatibility"; today we call it crony capitalism (Jeffrey A.

Frankel, "The Asian Model, the Miracle, the Crisis and the Fund", Speech delivered at the US International Trade Commission, April 16, 1998).

(5)
If...the fundamental trigger of crisis in each case was a decline in investors' confidence in the soundness of the long-term investments backing up their short-term deposits, then there would be no necessary reason to expect the same macroeconomic precursors in each case. Instead, in a financial system organised around relationships rather than information, the confidence of investors in the soundness of relationship lending itself is an absolute fundamental. And the potential for contagion from one country to another may depend more on the extent to which investors perceive similarities between the two countries' financial systems than on the extent of actual similarity (Janet Yellen, "Lessons from the Asian Crisis", Council on Foreign Relations, New York, April 15, 1998).

(6)
Like other financial crises of years past, the Asian crisis can be traced to a set of interrelated problems. In this case, three factors predominated; financial-sector weaknesses cum easy global liquidity conditions; problems in the external sector, and contagion running from Thailand to other economies (Morris Goldstein and Dennis Weatherstone, "The Asian Financial Crisis", **International Economics Policy Briefs, 98-1**, Washington: Institute for International Economics, March).

(7)
...all the tiger economies suffered from too much cheap money, combined with a financial system that failed to allocate it efficiently. Banks did not assess credit risks properly, lending largely on the basis of personal relationships, and taking on risks in the belief that the government would always bail them out. Bank supervisors were at best incompetent, at worst corrupt. ("East Asian Economies Survey", **The Economist**, March 7, 1998, p. 7).

(8)
We in Malaysia laughed at the suggestion that our country would follow the fate of Mexico. How could that happen when our economy was so sound? We had practically no foreign debt. Our growth was high....Quite a few people in the media and in control of the big money seem to want to see...Southeast Asian countries, and in particular, Malaysia, stop trying to catch up with their superiors...There may be no conspiracy as such, but it is quite obvious that a few at least...have their ow agenda which they are determined to carry out.
We have always welcomed foreign investments. including speculation...But when big funds use their massive weight in order to move...shares up and down at will and make huge profits by their manipulations, then it is too much to expect us to welcome them, especially when their profits result in massive

losses for ourselves (Prime Minister Mahathir interview, **Far Eastern Economic Review**, October , 1997, p. 32).

(9)
If we are to piece together the lessons of the recent crises and devise an effective approach to these issues it will be important to start from the right place. Some conjure a specter haunting the world's governments; the global capital markets whose advances they cannot resist, whose sudden rejections they cannot survive. The facts of the most recent financial crises tell a different story.

The truth is that the crises that have occurred have disproportionately involved the judgements of countries' own citizens. Careful studies by the G-10 and the IMF of the crises in the European exchange rate mechanism and the Mexican peso crisis were able to attribute only a small fraction of the capital flows involved to speculative trade by foreigners....I understand that these studies have been echoed in the very recent IMF study into the behaviour of hedge funds in Asia.

Where foreign capital has been involved it has most often been foreign capital that governments have sought actively to attract...we saw it in Thailand, in the tax breaks on off-shore foreign borrowing and other domestic incentives for Thai banks to take on unsustainable amounts of foreign debt; we saw it in Korea, where discriminatory controls kept long-term capital out, and ushered short-term capital in ("Deputy Secretary Summers Remarks before the International Monetary Fund", US Treasury, from the Office of Public Affairs, Washington, March 9, 1998).

(10)
...while there were significant underlying problems and weak fundamentals besetting the Asian economies at both a macroeconomic and microeconomic level, the imbalances were not severe enough to warrant a financial crisis of the magnitude that took place in the latter half of 1997. A combination of panic on the part of the international investment community, policy mistakes at the onset of the crisis by Asian governments, and poorly designed international rescue programs turned the withdrawal of foreign capital into a full-fledged financial panic, and deepened the crisis more than was either necessary or inevitable (Steven Radelet and Jeffrey Sachs, "The Onset of the East Asian Financial Crisis", Harvard Institute for International Development, March 30, 1998)

(11)
The vulnerability of the Asian economies was partly explained by the nature of domestic government intervention and by the fact that banks were often officially influenced conduits for loans rather than financially secure loans on their own behalf. Explicit and implicit guarantees help explain the scale and nature of domestic and international lending. So did the apparent elimination of foreign exchange risk. Finally a financial panic has caused- and is causing- greater damage than the underlying

weaknesses of these economies could justify (Martin Wolf, "Ins and Outs of Capital Flow", Financial Times, June 16, 1998).

(12)
I will argue that in order to make sense of what happened to Asia, it is necessary to adopt an approach quite different from that of traditional currency crisis theory. Of course Asian economies did experience currency crises, and the usual channels of speculation were operative here as always. However, the currency crises were only part of a broader financial crisis, which had very little to do with currencies or even monetary issues per se. Nor did the crisis have much to do with traditional fiscal issues. Instead, to make sense of what went wrong we need to focus on two issues normally neglected in currency crisis analysis; the role of financial intermediaries (and of moral hazard associated with such intermediaries when they are poorly regulated) and the prices of real assets such as capital and land (Paul Krugman, "What Happened to Asia?" mimeo, January 1998)

(13)
The crisis in Mexico taught us about the role of external imbalances and problematic macroeconomic fundamentals in leading to speculative attacks on currencies. Many of these factors were present in Southeast Asia. The real appreciation of many of the currencies in the region slowed export growth in some countries and een led to falling exports....At the same time imports continued to soar. The result was substantial current account deficits...

These macroeconomic factors are not sufficient to explain the Southeast Asian experience. What matters is not the size of the current account deficit but what is being used to finance and the form that the financing takes. Recently the evidence suggests that much of that investment has been directed towards excess (misguided) real estate investment. Furthermore financial institutions exposed themselves to greater risk by relying too heavily on short-term borrowing in foreign currency combined with long-term assets denominated in local currency. The crisis could not have happened without these failures in the oversight of the domestic banking system (Joseph Stiglitz, "More Instruments and Broader Goals: Moving towards the Post-Washington Consensus", The 1998 WIDER Annual Lecture, Helsinki, January 7)

(14)
...the Asian crisis cannot be separated from the excessive borrowings of foreign short-term capital as Asian economies loosened up their capital account controls and enabled their banks and firms to borrow abroad. In 1996, total private capital inflows to Indonesia, Malaysia, South Korea, Thailand, and the Philippines were $93 billion, up from $41 billion in 1994. In 1997, that suddenly changed to an outflow of $12 billion. Hence it has becom apparent that crises attendant on capital mobility cannot

be ignored (Jagdish Bhagwati, "The Capital Myth", **Foreign Affairs,** Vol 77(3), May/June 1998)

Underlying causes of the crisis

(1) Internal problems: The decline of technocratic influence

The emergence of the technocrat in South East Asia over the last three decades has been a much discussed feature of public policy-making throughout the region[17]. By the late 1960s, "every government in Southeast Asia was authoritarian to some degree, and economic planning agencies were playing significant roles in most of them". These agencies needed economists, statisticians and demographers and (to a much lesser extent) other social scientists who could easily interact with similarly trained people in the international and bilateral development agencies who controlled the flows of aid, so important to most regimes in the region. Foreign governments and foundations made generous funding available to train young Indonesians, Malaysians, Thais and Philippino graduates in western universities, especially in the USA. As these graduates returned, often with doctoral degrees, they moved into senior positions not just in planning agencies, but in central banks, ministries of finance, other government departments, and university research centres. Some were appointed to cabinet positions, usually as Ministers of Planning, or Finance, but in Indonesia, such technocrats also became at various times, Ministers of Agriculture, Health, Education, Trade, and Research. The Indonesian reliance on technocrats was indeed exceptional, but successive administrations in Thailand, Malaysia and the Philippines also appointed economists with foreign (usually American) graduate training to cabinet posts. In virtually no case did these appointees have to go through any form of electoral process.

To some foreign observers, this reliance on technocrats suggested that the ASEAN countries were following the "East Asian" model of the strong developmental state, derived from the experience of Japan, South Korea and Taiwan. This model emphasises the high degree of autonomy enjoyed by key decision-makers, especially in the bureaucracy. As Chalmers Johnson has argued in the context of Japan, the government "displays the usual qualities of an Asian kleptocracy only in its ruling party, but the party's functions in the Japanese system are to reign, not to rule. The latter is entrusted to an elite

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[17] John Bresnan, **Managing Indonesia: The Modern Political Ecoomy,** New York: Columbia University Press 1993, p. 72.

officialdom"[18]. Can we find any evidence of such insulated bureaucracies "ruling" in South East Asia? How autonomous were the central banks? Certainly the Bank of Thailand has enjoyed a considerable, albeit fluctuating, degree of independence over several decades and its technocrats were crucial in maintaining a stable monetary and fiscal policy regime through Thailand's years of accelerated growth. In Thailand, Indonesia and Malaysia, technocrats in the Ministries of Finance also had considerable success in insulating key areas of macroeconomic policy-making from overt political interference[19]. In Thailand and Indonesia, for example, the administration of duty drawback schemes, crucial to the rapid growth of a number of export-oriented industries, were placed in the Ministries of Finance to minimise corruption and malpractice[20].

But at the same time some authors have claimed that policymakers in the fast growing economies of South East Asia have always been ready to listen to influential business lobby groups, who in their turn have been catalysts of policy reform, and active in promoting structural adjustment measures. In the case of Thailand, both Doner and Laothamatas and Rock argue that the successful implementation of a series of structural adjustment measures in the years from 1980 to 1985 was due in large measure to the

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[18]Chalmers Johnson, **Japan: Who Governs? The Rise of the Developmental State,** New York: W.W.Norton, 1995, p. 68

[19]See Peter G. and Bhanupong Nidhiprabha , **Thailand's Macroeconomic Miracle: Stable Adjustment and Sustained Growth**, Washington: World Bank 1996, who discuss the role of the Bank of Thailand; Pasuk Phongpaichit, " Technocrats, Businessmen and Generals: Democracy and Economic Policymaking in Thailand", in Andrew J. MacIntyre and K. Jayasuriya (Editors), **The Dynamics of Economic Policy Reform in South-east Asia and the South-west Pacific**, Singapore: Oxford University Press, 1992, examines the interaction between technocrats and business leaders in economic policy-making in Thailand in the early 1980s. See also Jomo, K.S., **Southeast Asia's Misunderstood Miracle: Industrial Policy and Economic Development in Thailand, Malaysia and Indonesia**, Boulder:Westview Press, 1997, who examine the role of the bureaucracy in Malaysia. Bresnan, op. cit., Chapter 3 and David C. Cole and Betty F. Slade, **Building a Modern Financial System: The Indonesian Experience**, Cambridge University Press, 1996, Chapter 10, all discuss the role of technocrats in economic policy-making in Soeharto's Indonesia.

[20]Yoshihara Kunio, **The Nation and Economic Growth: The Philippines and Thailand,** Kuala Lumpur: Oxford University Press, 1994, Chapter 18 contrasts the performance of the bureaucracy in Thailand and the Philippines after 1960, and concludes that in Thailand government interventions were far more pro-market and supportive of rapid capital formation in the private sector than in the Philippines, especially in the martial law era.

government's successful attempts to build effective alliances between technocratic advisers (usually academic economists with strong neo-classical sympathies), key politicians, and business groups[21]. While, as Pasuk points out, it is difficult to fit Thailand with its notoriously weak planning apparatus, into the strong developmental state model, it is also wrong to assume that the government did nothing to facilitate industrial expansion[22]. Interventions in both capital and labour markets were crucial and often carried through at the instigation of, and with the full cooperation of, powerful industrial groups.

On the basis of the development experience of Malaysia, Thailand and Indonesia in the 1980s and early 1990s, it has been suggested that the states of South East Asia comprise an intermediate case between the strong developmental states of Northeast Asia (Singapore would certainly be included in this group) and the notorious 'klepto-patrimonial" regimes of Africa such as Nigeria or Zaire[23]. Their governments did not appear to be hopelessly captured and corrupt, but on the other hand they were frequently beholden to sectional interest groups, and tainted by nepotism and cronyism. Nevertheless the Malaysian, Thai and Indonesian governments clearly were capable of coherent policy formulation and implementation in the face of external shocks, and were able to maintain the momentum of growth over several decades. In this they ressemble Taiwan and South Korea to a greater extent than regimes in other parts of the developing world.

What then went wrong? A leading Thai economist has argued that the power of the technocrats over macroeconomic policy in Thailand was strongest when army governments were in power;

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[21] Richard Doner and Anek Laothamatas,"Thailand: Economic and Political Gradualism" in Stephan Haggard and Steven B. Webb (Editors), **Voting for Reform,** New York: Oxford University Press, 1994
Michael Rock, "Thai Industrial Policy: How Irrelevant was it to Export Success?", **Journal of International Development**, 1995, Vol 7 (5), pp. 759-773

[22]Pasuk Phongpaichit, "The Thai Economy in the mid-1990s", **Southeast Asian Affairs, 1996,** Singapore: Institute of Southeast Asian Studies, 1996.

[23]Andrew Macintyre, "Business, Government and Development: Northeast Asian and Southeast Asian Comparisons" in Andrew Macintyre (Editor), **Business and Government in Industrialising Asia,** Ithaca: Cornell University Press, 1994.

> whenever the army's power waned, the power of the technocrats would go into eclipse. Because of the need for patronage on the part of the elected politicians, technocrats began to have an adversial relationship against them, and naturally sought the army as allies to push their case and to protect them[24]

Professor Siamwalla goes on to argue that the "quality and competency of the Thai civil service has been declining, precipitously during the last decade", and this has inevitably affected the formulation and implementation of macroeconomic policies. The Bank of Thailand, usually considered among the more independent of the Asian central banks, and certainly a bastion of probity within the Thai financial system, was also the object of increased political interference. Governors began to be dismissed by the Minister of Finance during the 1980s, which inevitably led to collusion between Governors and Ministers of Finance to minimise conflict over policy objectives. In particular, an independent monetary policy was sacrificed to the goal of maintaining the fixed rate of the baht against the dollar.

In Indonesia also, the influence of the economic technocrats who had been so influential from the very beginning of Soeharto's new order regime, appeared to be on the decline by the early 1990s. A key turning point was the announcement of the cabinet after Soeharto's re-election for a sixth term as President in 1993; to many observers the role of the Minister of Research and Technology, Dr Habibie, seemed stronger and that of the economists much weaker. Dr Habibie was well-known for his scepticism about "orthodox" economics and his enthusiasm for spending large sums on ambitious technology projects such as the State Airplane Enterprise in Bandung[25]. Certainly he had a close relationship with President Soeharto, and during the years from1993 to 1997 had some highly publicised battles with the Minister of Finance (Mar'ie Muhammad) over his spending plans. But however great his influence with the President was, it was also becoming increasingly clear that an ageing

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[24] Ammar Siamwalla, "Can a Developing Democracy Manage its Macroeconomy? The Case of Thailand", **TDRI Quarterly Review,** Vol 12 (4), December 1997, pp. 6-7

[25] Ross McLeod, "Survey of Recent Developments", **Bulletin of Indonesian Economic Studies,** Vol 29(2), August, 1993.

President with almost three decades of service behind him, was paying less and less attention to any member of his cabinet. By far the most influential people were his immediate family and a small group of their business associates. Cabinet ministers challenged the wishes of the first family and their courtiers at their peril.

Soeharto made a last-ditch attempt to use his technocrats to stave off economic disaster in the aftermath of the Thai devaluation, but ultimately to no avail. In fact it appears that the technocrats, especially in the Ministry of Finance, used the opportunity of the first IMF agreement to insert conditions concerning deregulation of the "real" economy, especially the abolition of state and private monopolies and other perquisites of the Soeharto family. A prominent Indonesian economist has argued that such measures were "voluntarily proposed" by the technocrats to increase the credibility of the package, both to the Indonesian public and to the international markets[26]. Needless to say, Soeharto was having none of this, and so what the technocrats feared in fact came true. Both domestic and international condidence collapsed and with it the rupiah. By January 1998 much of corporate Indonesia was in effect bankrupt.

(2) Internal problems: Poor banking practices

As is clear from many of the quotes in Box 1, many international commentators have tended to blame imperfections in the financial system for the severity of the crisis which has hit South East Asia and Korea over the last year. The IMF in its **World Economic Outlook** for May, 1998 argued that one reasons for the crisis lay in

> financial systems, weak management and poor control of risks, lax enforcement of prudential rules and inadequate supervision, and associated relationship and government-directed lending practices that had led to a sharp deterioration in the quality of banks' loan portfolios (p. 3).

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[26]Hadi Soesastro and M. Chatib Basri, op. cit., p. 16. For a very similar argument in the context of South Korea, see Robert Wade, "The Asian Crisis: Debt Deflation, Vulnerabilities, Moral Hazard, or Panic", Russell Sage Foundation, May 1998, p. 12.

But this list raises a question; how many of these problems were the result of too rapid liberalisation of the financial system, which in turn was actively encouraged not just by the IMF but also by a range of other bilateral and multilateral development agencies? The financial development of Malaysia, Indonesia and Thailand has been extensively researched in recent years and until 1997 a principal finding of this research was that the deregulation and liberalisation of the financial sector had been an important factor contributing to rapid economic growth[27]. In their important volume on the Indonesian experience, Cole and Slade point out that "Indonesia initiated some financial reform measures in the late 1960s and early 1970s, well before such notions became fashionable, and it has followed a sequence of reforms that was the reverse of recently prescribed patterns"[28]. From 1970 onwards, Indonesia abolished most controls on outward capital flows, although inward flows, especially of direct foreign investment, remained subject to considerable government regulation, which was reduced gradually in the late 1980s and early 1990s. In 1995 the volume of daily foreign exchange transactions was estimated to be between $4.6 and $5 billion dollars, almost twice the volume of transactions in Thailand and six times that in Malaysia[29].

In spite of early liberalisation of capital flows, the Indonesian banking system remained highly regulated and dominated by a small number of state-owned trading banks until the 1980s. In 1983 ceilings on interest rates were removed and other measures taken to improve the efficiency of the banking system but the most sweeping reforms occurred in October 1988 when the government removed many restrictions on private banks, and made it easier for foreign banks to operate in the domestic economy. The result of these reforms was a dramatic expansion in the assets of private banks relative to those of the state banks; between 1988 and 1994 the share of the private national banks in total assets doubled from 22 to 44 per cent. Numbers of private banks proliferated and competition for new depositors became more intense. Real interest rates also rose over these years, and the ratio of broad money (coins, notes, demand and time deposits) grew.

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[27]Asian Miracle Report.

[28]Cole and Slade, op. cit., p. 3.

[29] M. Kuroyanagi and Y. Hayakawa, "Macroeconomic Policy Management and Capital Movements in Four ASEAN Countries in the 1990s", **EXIM Review**, June 1997, Table 6.

After 1991, it became clear that the rapid growth in the private banking sector was leading to problems. One of the largest private banks, Bank Duta, lost hundreds of millions of dollars as a result of foreign currency speculations by one employee. Another large private bank, Bank Summa, which was connected to a large industrial group ran into problems in 1992, and finally had its license revoked in 1994[30]. Were these episodes just minor accidents, inevitable in a process of rapid growth and diversification of the financial sector? Or were they symptoms of a deeper malaise? Some independent commentators pointed out the dangers of a proliferation of private banks, many of them offshoots of conglomerates whose core business was far removed from finance, and whose managers were usually inexperienced in banking. It appeared that a high proportion of the assets of some of these banks comprised loans to a small number of companies, often connected to the parent conglomerate. The dangers inherent in such practices may now seem obvious but Bank Indonesia, the central bank, seemed either unwilling or unable to take decisive action.

In their book, Cole and Slade expressed concern over the mounting evidence of cronyism in the financial sector, the increasing politicization of major investment decisions and predicted that, like most other developing economies, Indonesia would at some stage face a financial crisis, whose handling would provide "an important test of how sound a structure has been created". Two years later, they wryly conceded that "these cautionary assessments proved much too moderate"[31]. The rapid collapse of the Indonesian banking system in late 1997 and early 1998 necessitated huge liquidity supports from the central bank, and the eventual nationalisation in August 1998 of several of the worst affected banks. Cole and Slade are in no doubt that the problems in the Indonesian financial system were essentially political and argued:

> The failure to put together an effective initial response and the ultimate severity of the

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[30] John Chant and Mari Pangestu, "An assessment of financial reform in Indonesia, 1983-90" in G. Caprio, I. Atiyas and James A. Hansen, **Financial Reform: Theory and Experience**, Cambridge University Press, 1994, pp. 257-62.

[31] David C. Cole and Betty F. Slade, "Why has Indonesia's Financial Crisis Been So Bad?", **Bulletin of Indonesian Economic Studies,** Vol 34 (2), August, 1998, p. 62.

> Indonesian financial crisis must be understood and explained as the consequence of the lengthy process of politicisation of economic and financial activity within Indonesia, and the concomitant erosion of any effective prudential supervision over financial institutions by regulatory authorities, coupled with imprudent behaviour by many foreign lenders and investors.

(3) Internal problems: Ignoring the warning signals

In the wake of the problems in Thailand, Malaysia and Indonesia, there has inevitably been much discussion about economic indicators. How was it that so many experts were convinced that "sound fundamentals" would prevent the flotation of the baht from having a serious effect even on the domestic Thai economy, let alone on those of its ASEAN neighbours? Surely there must have been serious problems in all these economies which simply were not being picked up in the indicators which the pundits habitually consulted?

The indicator most frequently discussed in the context of Thailand, Malaysia and Indonesia by the mid-1990s was the balance of payments deficit. Certainly in both Thailand and Malaysia they were large enough, relative to GDP, to be ringing alarm bells in at least some quarters, but in Indonesia the deficit was much lower, at around 3-4 per cent of GDP. Furthermore the deficit was not the result of a large fiscal deficit, but rather the result of sustained high levels of private capital inflow, much of it long-term. In 1996, the current account deficit, corrected for inward flows of foreign investment was less than two per cent of GDP, hardly a worrying figure. There was some concern about the rising level of short-term debt (estimated in 1996 at around 73 per cent of foreign reserves), but compared with Mexico in 1994, this ratio did not appear very alarming.

Indeed several observers argued that the Indonesian government's concern about the current account deficit was unwarranted. It was argued that the Indonesian economy over the 1990s had demonstrated its capacity to compete in world markets for a broad range of goods, and indeed traded services such as tourism. The private sector should be encouraged to borrow freely offshore, and indeed the government should not attempt to regulate inward flows of private capital. The proper role of government should be to create a "level playing field" for all private sector investors, and remove unnecessary regulatory impediments to private sector activity[32]. These arguments reflected the so-called "new view" of the balance of payments, which held that it was not the size of the deficit that mattered but its causes. A current account balance, whether positive or negative is the net result of savings and investment decisions both public and private. If the government in a particular country habitually runs a large budget deficit and if this deficit is not matched by private savings, then a current account deficit will result. If this is financed by borrowing abroad as happened in a number of Latin American countries then the probable outcome would be a debt crisis, especially if the loans were at variable rates, and world interest rates were to rise.

But what if the government budget were in balance or even in surplus, but a balance of payments deficit were to emerge as the result of a sharp increase in domestic investment by the private sector? Such investment could be directly financed by inward investment, or it could be financed by a domestic investor who funds the investment through a foreign loan. In these cases the domestic investment is tightly tied to an inward capital flow, and the current account deficit (if there is one) can be seen as the net result of the investment decision. If the private investment decision was based on sound judgement about the productivity of capital in that particular economy, then the current account outcome should not be a matter of policy concern to the government. If the investment decision turned out to be unsound, then the cost would be born by the investor, whether domestic or foreign and the bank which lent the money. There would be no cost to the government or to other private actors in the economy[33].

In the latter part of the 1980s and early 1990s a number of economies, both in ASEAN and elsewhere, ran substantial current account deficits when government budgets were balanced or in surplus. This "new" view of the current account became quite influential, in ASEAN as elsewhere. If the balance of payments deficit

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[32]See Ross McLeod, ASEAN Economic Bulletin, July 1997.

[33]For a lucid discussion of the new view see W. Max Corden, **Economic Policy, Exchange Rates and the International System**, Oxford University Press 1994, Chapter 6.

was financed by (in fact caused by) large inward flows of direct investment, as in Indonesia or Malaysia, where was the problem? Foreign firms formed a judgement about the profitability of investment in these economies and invested accordingly. If their decision proved wrong, they and their shareholders and their bankers (in Japan shareholders and bankers are often one and the same) would bear the cost. Even where the balance of payments deficit was financed by portfolio inflows, doctrinaire supporters of the "new view" argued that there was no problem[34]. Foreigners invested in Indonesian equities, or lent directly to Indonesian firms, because returns adjusted for the risk of exchange rate depreciation, were seen to be high. If governments continued to implement policies which led to high growth and high profitability of private investment, then there was little risk of sudden and massive withdrawal of capital.

Some analysts recognised that there were problems with the "new view". Most obviously there is the very real possibility that investors might find they have made errors of judgement in their projections of rates of return. If this happened for a few small investments it would hardly matter; the costs would be born by the investor and by whomever lent to that investor. But if some large, high-profile investments were to turn sour for whatever reason, could this not lead to a loss of confidence, which in turn could trigger large-scale capital flight? Obviously withdrawal is easier, although not costless for portfolio investors but foreign companies have not infrequently closed plants which they perceive to be unprofitable in many parts of the world. And foreign bankers can refuse to roll over short-term loans to corporate clients suddenly perceived to be high-risk borrowers.

It now seems clear that this is what happened in Thailand, Malaysia and Indonesia in varying degrees in 1997/8. It is also clear that the "new view" of the balance of payments, to the extent that it was influential in ASEAN, probably induced a sense of false complacency in at least some policymakers. It is is certainly valid to argue that a current account deficit may not be a legitimate cause for government policy intervention if it is the result of high levels of private investment. But it hardly follows that the ASEAN countries were correct in taking a relaxed view of sustained current account deficits , even where they were largely covered by inward flows of

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[34]See e.g. Ross McLeod, op. cit.

direct investment. At the very least such deficits should have encouraged policymakers to take other warning signals more seriously. In the Indonesian context, these included the high level of foreign borrowing by the Indonesian corporate sector, much of which financed investment in the non-traded goods sectors, together with the rapid growth of politically motivated lending by Indonesian banks to domestic firms.

(4) External Problems: The behaviour of the IMF

One of the more extraordinary consequences of the Asian crisis has been the barrage of criticism directed against the International Monetary Fund (IMF). Criticism of the IMF and its role as a lender of last resort is not new but never has it had to endure so many sustained attacks from such a range of critics. Indeed by late 1997 it was almost universally argued that the IMF's actions in Thailand, Malaysia and Indonesia were aggravating what was already a bad situation; some economists were going much further and claiming that it was actions of the IMF which precipitated the crisis.

Foremost among the American critics of the IMF has been Jeffrey Sachs of Harvard University; his views have been given wide coverage in the international media and through the internet. In the Indonesian context, his arguments are as follows. There was no economic reason for the collapse of confidence in the rupiah in late 1997; unlike Thailand export growth had stayed strong in 1996, the current account deficit was much smaller relative to GDP, the budget was in overall surplus, credit growth was not excessive, foreign liabilities of the commercial banks were substantially below those in Thailand and in South Korea and there had been no spectacular corporate bankruptcies, again in contract to South Korea and Thailand. The Indonesian government in fact responded to the crisis more sensibly than other countries in the region, although some mixed signals were sent about government willingness to curb investment projects in which the Soeharto family were heavily involved. In fact in October 1997, Indonesia did not seem an obvious candidate for an IMF programme. The first of the IMF programmes signed at the end of October in fact stabilised the rupiah but in early

November the rupiah slid alarmingly, and it was at this point that Indonesia began to look worse than its neighbours.[35]

The reason for the collapse was panic, induced in part by government actions such as the closure of sixteen banks in early November. Radelet and Sachs admit that political factors were responsible for much of the panic and indeed "the economic and political issues have fed off each other, adding a whole new dimension to the dynamics of the panic". They also concede that the very severe drought aggravated the problem by causing serious food shortages in some areas. But they appear to imply that the IMF was responsible for at least aggravating the panic if not for initiating it in the first place, and thus for provoking an unnecessary real contraction in the Indonesian economy.

An alternative view, which I think is more persuasive, is based on the arguments of Cole and Slade cited above. This sees the IMF as essentially responding to events rather than provoking the crisis. According to this argument, the financial sector's problems reflected deeper problems of nepotism and corruption, which by the mid-1990s permeated the entire government system. As the crisis deepened it became clear that the administration, and the elderly autocrat who led it, were more concerned with protecting family and cronies than with the health of the economy. Years of "crony capitalism" had taken a severe toll not just in terms of public confidence but also in terms of the regime's ability to respond to a serious economic crisis. The behaviour of the IMF may not have been well judged or especially skilful, but to blame them, or any other external power for what happened is to miss the central point. The Soeharto regime finally collapsed because of its severe internal problems, and because of policy mistakes and wilful negligence, whose cumulative impact finally destroyed the credibility of the regime both at home and abroad.

Many other IMF critics have emerged over the past few months. Some have argued that their policy prescriptions in Thailand and, to begin with at least, Indonesia appeared to have been drawn from the experience of previous crises in Latin America, even though the causes of the currency falls in South East Asia were very

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[35]This is a summary of the argument to be found in Steven Radelet and Jeffrey Sachs "The Onset of the East Asian Financial Crisis", Harvard Institute for International Development, March 30, 1998

different. Thus the fund imposed conditions relating to budget surpluses on both Thailand and Indonesia, even though everyone agreed that irresponsible government spending was not the cause of the problem in either country. Other criticisms relate to the secrecy under which the IMF operates (even though it urges greater transparency on its client governments) and its bias in favour of western governments and financial institutions[36]. Some of these criticisms may well be true although the IMF has relaxed some of its conditions in Thailand in response to Thai government requests, while in Indonesia it has little choice but to accept a budget deficit projected to reach 8.5 per cent of GDP in 1998/99. The budget blowout in Indonesia is the result of the rising costs of subsidies on the one hand and falling domestic and oil tax revenues on the other. Although most of the deficit will be financed from foreign aid and loans in the current financial year, it is unsustainable in the longer term[37].

But even if some of the criticism of the IMF in the Indonesian context is not very persuasive, there can be little doubt that the crisis there and in other parts of the region has dealt a severe blow to the prestige and the credibility of the Bretton Woods institutions. If neither the IMF nor the World Bank could predict the crisis, or come up with sensible policy measures once it hit, then what is the point of having them? Have they both become expensive anachronisms, intellectually as well as geographically remote from their most important clients? Indonesia has been one of the World Bank's largest borrowers for over three decades, and it is difficult to believe that neither it nor the IMF were aware of the political problems which were all too obvious to most observers by 1996. Why did they not have contingency plans in place for the kind of crisis which erupted in late 1997 and early 1998?

One reason why the international development institutions appear to have been so negligent in their assessments of economic conditions in South East Asia may well have been that they were relying on Japan to play a much more prominent role in any rescue programme. It is widely acknowledged that Japanese loans were crucial in helping the Indonesian government adjust to a regime of

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36 See K.S. Jomo "Introduction" in K.S. Jomo (Editor), **Tigers in Trouble: Financial Governance, Liberalisation and Crises in East Asia,** London: Zed Books, 1998.

37 See World Bank, op.cit., Table 2.2

lower oil prices in the years from 1983 to 1986 without having to seek aid from the IMF. It is probable that the IMF, not to mention Soeharto and some of his key advisers expected Japan to help again in 1997. In the event the Japanese government facing a serious economic recession and major problems in its own banking system was unwilling to help except as part of an IMF package. This threw the burden of policy conditionality on the IMF, a burden which they have found increasingly difficult to cope with over the past 12 months.

Estimates of the impact of the crisis on poverty and living standards

While the literature on the causes of the crisis in Indonesia exploded in the early and middle months of 1998, the economic situation in the country itself continued to deteriorate. It became clear that the impact of the crisis on living standards would be serious. In July and August 1998, three separate sets of estimates of poverty in Indonesia for 1998 and 1999 were published. The first was included in a World Bank report published in July, the second was prepared by the Indonesian Central Board of Statistics, and the third was published by the International Labour Organisation[38]. These three estimates used different methodologies to evaluate the effect of the crisis on poverty and came up with rather different answers to the fundamental question: what will be the impact of the crisis on the poor and vulnerable groups in Indonesian society?

The World Bank report argued that in mid-1997, before the crisis hit, around 10.1 per cent of the population was below the official poverty line. This can be compared with the official estimate of 11.3 per cent below the poverty line in early 1996 (Department of Information 1998: Table IV-1). According to the World Bank, a contraction of GDP of around 12 per cent in 1998 could push the incidence of poverty up to 14.1 per cent of the population in 1999. This would imply 29 million people in poverty (World Bank 1998: 32-33). The World Bank argued that the most visible effects of the crisis would be in urban areas, and numbers in poverty would increase more rapidly in percentage terms in urban than in rural areas. But the increase in absolute numbers of poor would be higher in rural areas, and especially in those areas most affected by the El Nino drought. These areas included provinces such as East Nusatenggara, Irian Jaya and East Timor where the incidence of poverty was already much higher than the national average, and

[38]See **Indonesia in Crisis: A Macroeconomic Update** (Washington: World Bank July, 1998), **Employment Challenges of the Indonesian Economic Crisis** (Jakarta: International Labour Organisation and UNDP, June, 1998), and **Lampiran Pidato Kenegaraan** 1998 (Jakarta: Department of Information 1998).

where large numbers of households were very vulnerable to declines in output and incomes[39].

A much more pessimistic set of estimates were prepared by the Central Board of Statistics (CBS) and incorporated in the Appendix to the State Speech of President Habibie, published in August, 1998. These data indicated that by mid-1998 the proportion of the population below the official poverty line would jump to 39.9 per cent compared with 11.3 per cent in 1996. This percentage translated into 79.4 million, compared with 22.5 million in 1996. This dramatic increase was based on the key assumption that the poorer groups in both urban and rural areas would experience a sharper decline in income than the fall in average GNP. The CBS estimated that low income groups in urban areas had experienced a fall in real income of 44 per cent up to June 1998, while in rural areas the fall was 54 per cent[40]. The justification for this assumption was based on trends in wage incomes of poorer groups in society in the boom years from 1990 to 1996. The reasoning was that the poorer groups had experienced a faster growth in incomes over these years; therefore they would experience a faster decline as a result of the contraction which occurred in 1997-98.

The CBS estimates also assumed a rather faster rate of inflation in rural areas compared with urban areas and argued that the impact of the government "social safety net" schemes would not be very great, at least up until the end of 1998. They further assumed that there would not be any marked change in the distribution of household expenditure by expenditure group in either urban or rural areas compared with that shown by the 1996 SUSENAS Household Expenditure module. Thus the poverty line for both urban and rural areas was adjusted upwards by the projected decline in real incomes, and applied to the 1996 expenditure distribution. In this way the estimates of poverty incidence in mid-1998 were derived (Table 1)

The ILO estimates assumed that average wage rates and household incomes would not change in nominal terms over 1998-99. As in the CBS estimates, the ILO assumed that the distribution of expenditures would not change compared with 1996, but that cumulative inflation over 1998 would lead to an 80 per cent increase

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[39]See Department of Information, op. cit., 1998: Table IV-4 for estimates of poverty by province for the years 1990, 1993 and 1996.
[40]Unpublished data from the Central Board of Statistics.

in prices of basic staples. In 1999 prices of basic needs were projected to increase by a further 25 per cent. Adjusting the official poverty line to allow for these price increases, the ILO report found that by the end of 1998, the proportion under the poverty line would rise to 48 per cent (39 per cent of the population in urban areas and 53 per cent in rural areas. By the end of 1999 (assuming further inflation of 25 per cent and stagnating nominal incomes) 66 per cent of the population could fall under the poverty line (57 per cent in urban areas and 72 per cent in rural areas). This indeed would imply that the incidence of poverty would be much higher than at any time since 1976, when the CBS began to publish poverty estimates. In that year the CBS estimated that 40 per cent of the total population fell below the official poverty line. Both the CBS and the ILO figures indicate that absolute numbers below the poverty line are higher than at any time since the mid-1970s (Table 1).

Are the CBS and ILO projections too pessimistic? Certainly it is not immediately obvious why a reduction in the household consumption component of GDP of perhaps 15 per cent would lead to such a huge increase in the proportion of the population under the poverty line[41]. In addressing this paradox, there are two distinct issues which need to be examined; the impact of the crisis on nominal incomes and the impact on inflation. The CBS estimates assume a slight fall in nominal incomes while the ILO estimates assume that they will not change compared with 1997. Yet the available evidence indicates that in some parts of Indonesia, nominal incomes have increased quite rapidly over the past year. Not surprisingly the most optimistic reports come from regions where a substantial part of the population is involved in cash crop production for export[42]. It would appear that rupiah prices of most export crops (rubber, coffee, pepper, cocoa, tea, spices, palm oil, copra) have increased rapidly over the past year and indeed the rate of increase has been considerably faster than rice prices (Table 2). While it is true that not everyone even in those regions where export production predominates will benefit from these higher prices, many

[41]It is likely that the household consumption expenditure component of GDP will fall less than either government consumption expenditures or investment expenditures and thus less than total GDP.

[42]In the first four months of 1998, volume of agricultural exports doubled compared with the first four months of 1997, and dollar earnings increased by 35 per cent. Dollar earnings from manufactured exports grew by 10.4 per cent over the same period. See **Buletin Ringkas**, Jakarta: Central Board of Statistics, July 1998, Table 18.

millions will do so, and many more will benefit indirectly from the expenditure effects of the export boom[43]. Thus the assumptions of the ILO and the CBS that nominal incomes will stagnate (or actually decline) may be true for Java and some parts of Eastern Indonesia but are clearly too pessimistic for other parts of the country.

In addition it needs to be stressed that dollar earnings from manufactured exports also grew in the first four months of 1998 compared with the same period in 1997, although not as rapidly as earnings from agricultural exports. Although some labour-intensive industries such as garments experienced a contraction in output, others managed to survive the economic dislocation and increase export earnings. The employment effects of this increase are difficult to estimate but they suggest that extreme pessimism about declining employment and incomes in the manufactured export sector may be misplaced.

At the same time both the CBS and the ILO estimates are surely correct in drawing attention to the severe implications for poverty of continued high rates of inflation. As would be expected, the rapid devaluation of the rupiah since August 1997 has led to a much more rapid increase in the price of traded good (especially food and clothing) than non-traded goods such as housing. The composite 44-city Consumer Price Index shows that by July 1998, food prices had risen 83 per cent compared with December 1997, but housing prices had risen by only 36 per cent[44]. As food accounts for a higher share of the consumption basket of the poorest groups, the effect of the higher inflation of food prices will be much more serious for them than for better off groups. This differential impact of inflation is in fact quite well known in the Indonesian context. Asra demonstrated that during the early part of the 1970s when food prices rose

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[43]The 1993 Agricultural Census (Series D 1, Table 3) indicates that in ten provinces outside Java average farm household income from smallholder treecrop cultivation exceeds income from foodcrop cultivation. In a further four provinces, income from treecrop cultivation is only slightly lower than from foodcrop cultivation. In such households a rapid pass-through of the effects of the devaluation will lead to a considrable growth in household income. Although some of ths growth will be offset by inflation, such houeholds should experience some growth in real incomes over 1998 and into 1999, even allowing for the impact of the drought on production.

[44]**Buletin Ringkas,** July 1998, Table 1.

rapidly, the cost of living index of the poorest 40 per cent increased faster than for other groups in both urban and rural areas[45]

Thus even if the CBS and the ILO estimates are rather too pessimistic in terms of their assumption about growth in nominal and real incomes, especially outside Java, their poverty projections may well turn out to be correct if increases in the price of basic food staples cannot be controlled. This indeed is probably the main challenge for the Indonesian government in the last part of 1998 and early 1999. The reasons for the dramatic increase in rice prices in 1998 are in fact far from clear The forecast for paddy production in calendar year 1998 announced by the CBS in August 1998 was 46.29 million tons, a decline of 6.25 per cent from the 1997 harvest and a decline of 9.4 per cent from the record harvest of 1996 (51.102 million tons)[46]. But the government had been aware of the probable shortfall for months, and had already imported almost 3.5 millions tons by August 1998, with a further 0.6 million tons to be imported by the end of the year. The government logistics agency (BULOG) claimed to be injecting rice into key urban markets at a high level. By early September, government ministers were blaming hoarders and speculators for the price increases[47]; public frustration was increasingly being vented against traders and shopkeepers in a spate of riots throughout Java and in some parts of Kalimantan and Eastern Indonesia.

What is Left of the Indonesian Miracle?

"There is hardly a more conventional subject in economic literature than financial crises" writes Professor Kindleberger; his scholarly work has done much to reveal to contemporary economists both the causes and consequences of financial crises in the international economy over the past two centuries. Capitalist economic growth has often been rapid and has not infrequently led

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[45]Abuzar Asra, "Inquality Trends in Indonesia 1969-81: A Re-examination", **Bulletin of Indonesian Economic Studies,** Vol 25 (2), August 1989

[46]Other estimates put the 1998 production figure at only 45 million tons; see Tabor, Dillon and Sawit (1998), Table 2. These authors also point out that not all households classified as poor by the official definition will be severely food insecure. They suggest that around 32 million people will fall into this category in 1998.

[47]See Jakarta Post, September 1, 1998. The government responded to public dissatisfaction with the performance of BULOG by dismissing the agency's head in August. The Ministers of Cooperatives and of Trade and Industry were given joint responsibility to supervise food stocks and food distribution.

to the dramatic transformation of cities and regions in short spaces of time. But such growth has almost always been cyclical. It was only after 1950 that the golden era of economic growth in Western Europe, North America, and Japan encouraged optimists to believe that sustained economic growth characterised by at worst mild cyclical swings might be achieved in the world economy. Even after economic growth slowed in much of Western Europe and North America in the latter part of the 1970s and 1980s it continued apace in most of East and South East Asia. Not only did Japan continue to grow faster than most of the other OECD economies, but South Korea, Taiwan, Hong Kong, Singapore, Thailand, Malaysia and Indonesia all managed to sustained rapid economic growth from the 1960s into the 1990s. After the Deng reforms of the late 1970s, China also joined the race with a will. And so the East Asian Miracle was born.

Three decades of unprecedented economic growth were certainly more than enough to create the 'displacement' effect which Kindleberger sees as the first phase of an economic crisis. The sustained growth, and greatly increased savings, combined with substantial financial liberalisation inevitably led to speculative activity concentrated especially in urban real estate. By the early 1990s there were clear signs of financial sector distress, but they were not really viewed as serious. Full-scale panic only set in after the flotation of the baht; it was fuelled not just by the demand for foreign exchange to hedge overseas borrowing, but also by a collapse of confidence in the ability of South East Asian governments to tackle their economic problems. In Indonesia the problem of confidence was aggravated by the fears of the Chinese minority of government and army-provoked violence.

What are the lessons? Are crashes the inevitable consequence of booms in capitalist economic systems? Perhaps yes, but the severity of the crash, and the protracted nature of the recovery process in Indonesia, as in neighbouring countries, implies that, as in Latin America in the 1980s, at least a decade's economic growth will be lost. In order to avoid future crises, it is imperative that lessons be learnt. For Indonesia in particular there are at least three crucial lessons to emerge from the bitter experiences of the last year:

(1) Recognise that all economies are prone to financial crises and respond more aggressively to warning signs. There can be little doubt that the sustained growth of the last three decades in Indonesia led many policy-makers and businesspeople to believe

that they were immune to the economic fluctuations which afflicted the OECD economies. In particular the fact that East Asia was largely unaffected by the severe downturn of the early 1990s created a climate of false optimism which in turn encouraged speculative investment in several sectors, and aggravated the cronyism and corruption in ruling circles which had already become a serious problem in the 1980s.

(2) Policies involving the imposition of a currency peg, together with exchange controls, should be resisted. What such policies would amount to is a tax on producers of traded goods, the very people who must be relied on to spearhead an economic recovery. As inflation accelerates, the rupiah will have to decline in order to maintain its real value, and thus the real incomes of the tens of millions of Indonesians who produce exports and import substitutes. The re-imposition of exchange controls, abandoned in Indonesia in the late 1960s would lead to a resurgence of the black markets and smuggling which characterised the 1950s and 1960s. This in turn would create new opportunities for corruption and rent-seeking even as the government tries to cope with the bitter legacy of the Soeharto years. Similarly the use of subsidies to control inflation is almost certainly counter-productive. Many of the current subsidies (such as those on petroleum products) are not of any direct benefit to the poor but are designed to prevent middle-class unrest. They are the main reason for the large budget deficit which will certainly increase inflationary pressures in the domestic economy, even if it is funded largely by foreign aid and borrowing. To the extent that the government is tempted to fund the deficit by having recourse to the printing presses, the scene is set for a return to the disastrous hyperinflation of the early and mid-1960s.

(3) Dont directly control foreign direct investment inflows or portfolio flows but develop policy tools to prevent speculation. Controls on the inward flow of capital could only damage Indonesia's economic recovery by deterring new investment and encouraging established investors to leave. At the moment any discussion of controls on inward flows of portfolio capital are rather beside the point as there are none, and such discussion could only act as a deterrent to genuine investors. In the medium term some form of tax on short-term inflows such as that applied in Chile may be a useful tool for curbing speculative inflows.

(4) Indonesia like other governments in South East Asia must develop strong independent regulatory and audit agencies which can police not just the financial sector but also government departments and state enterprises. In the past the weakness of government audit agencies have been blamed for many of the problems in the state enterprise sector as well as in line ministries.