

Anatomy of a Crisis ¹

by
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I. Introduction

Indonesia's crisis has been dragging over a year without any clear sign when it will stop. The crisis has multifaceted aspects, ranging from political, economic, social and cultural; its scale is so wide that no sector of life, from day-to-day economy, bureaucracy and political format to social construction, is free from its impacts. To understand the nature of today's crisis, we must look back and take a glance at the structure of Indonesia's past for the last three decades, with a particular analysis on the political-economic situation during the past year.

The crisis marked the end of the New Order regime under President Soeharto--although many would argue that today's administration is just a remnant of Soeharto's regime. All was started when Soeharto and his New Order regime came to power in 1966, inherited a decayed political structure and crumbled economy. When he stepped down from his presidency on May 21, 1998, he left behind an economic and political turbulence^{that} left Indonesia's total (public and private) foreign debt as much as \$134 billion, 80% depreciation of rupiah to US dollar, an inflation rate of 60%, negative economic growth, and poverty increase of 19,5 to 80 million people within one year.

Thus, it is important to assess the New Order's political-economic structure and providing an anatomy of the crisis. Mapping of the wrong track the government of Indonesia has taken would provide a better look at the present problems and might be a help in trying to predict the viability of the political and economic format in the (near) future. Finally, although it seems speculative, there are some possible venues to overcome the crisis, or at least to see the dimmest light of economic and political recovery.

II. Fragile Financial Structure and Power Franchise System of the New Order

It is now slightly more than one year since the economic crisis began. While it may be too optimistic to say that the storm has passed, there is at least an emerging consensus on what needs to be done to get Indonesia's economy back on track. But to understand the policies that will quite probably restore the country's economy to some measure of health, we need to understand the underlying weaknesses that caused the crisis. It is therefore important to focus first on the issues that caused Indonesia's economic collapse before turning into policies that will help rebuild the economy.

Single variable explanations are always suspect, but this is particularly true when we look at the current economic crisis. No one who has seriously reviewed the evidence can believe that a single, simple explanation will suffice. The economic meltdown, and one can hardly describe it differently, that has hit Indonesia, had multiple causes. Some were self-inflicted, others were external.

One of the popular explanations of the Asian crisis argues that runs on financial institutions currencies triggered the crisis and then helped spread it. The argument posits that a generalized run on financial institutions will severely disrupt economic activities by weakening the balance sheets of borrowers and creditors and by threatening the flow of credits, and hence the viability of the payments system.² In an open economy such as Indonesia, a simultaneous run on the banks and on the currency weakens the balance sheets of borrowers who have failed to hedge the borrowed funds or have relied on short-term credits to finance long-term investments. And a run on one currency, such as was experienced in Thailand, will quickly raise doubts about the strength of other regional currencies, setting off an economic contagion. Thus, the Baht- Rupiah chain!

The above explanation is not wrong, but it does not go far enough. Inherent in this explanation is the assumption that the Asian economies were "fundamentally sound" and they could have continued to grow for a very long time were it not for an arbitrary short in market expectations that interrupted the flow of funds.³

Economic indicators seem support this assumption. Before July 1997, Indonesia's economic performance was said close to excellence. The economy was booming, as shown by some indicators: high economic growth; single-digit inflation; discipline in fiscal policies; high rate of public savings; prudent macroeconomic

policies. What this explanation omits is any consideration of the weaknesses of Indonesia's macroeconomic fundamentals.¹ Only after these have been tackled in a candid manner can we look forward to a serious and sustained recovery.

Among the external events, the list includes a sharp decline in the world oil price, the decline in the prices for other primary product exports, and serious drought that plagued Indonesia's agricultural sector last year. Although exports still account for more than one-fifth of the total earnings, the impact of the sharp fall in world energy prices weakened Indonesia's balance of payments position and contributed to current government's account deficit. Although less well known,² we also suffered a substantial terms of trade shock last year. The world prices for a range of Indonesia's exports, including gold, copper, tin, coal, plywood and rubber, all declined sharply over the past year. By some estimates, if the world prices for eighteen major export commodities had remained unchanged in the first quarter of 1998 compared to the same period one year earlier, ~~our non-oil export growth~~ our non-oil export growth have been 18% rather than the officially recorded 12%.

And the drought that affected large parts of Indonesia also had a major impact on the economy. Most obviously, it reduced agricultural output. Agricultural growth in 1997 fell to less than one percent, sharply down from the 3% growth recorded in previous year. The lower agricultural output, especially the decline in rice production, also fueled the initial run up in consumer prices. As staple food, rice is always badly needed; a price hike is pushing all other consumer indices. At least through the end of last year, the increase in food prices reflected the impact of the drought rather than the fall in the value of the rupiah.

Obviously, these external shocks alone would not have caused the severe collapse the country eventually experienced. But neither can we neglect them when we seek to explain not only the economic downturn but also the severity of the economic crisis in Indonesia relative to that of our neighbors. For that we have to look at Indonesia's internal weaknesses. Perhaps the most glaring of these are found in the financial institutions, although an *a posteriori* assessment reveals that a fragile political structure also contributed much to the economic downfall.

Some critics have suggested that the banking reforms the government adopted in the 1980's resulted in the establishment of "too many banks." I am not sure how exactly one determines the optimal number of banks, so it is clear how one can argue that we allowed too many banks to open. Leaving aside the issue of the number of

banks, critics of banking reform have argued that with the sudden spurt in the number of banks, there was a shortage of adequately trained staff to carry out the necessary supervisory functions. As a result, the provisions of the banking laws were never effectively implemented. All of this may well be true, but the basic weaknesses of the country's financial system run deeper than that. Let me highlight only two

First, Indonesia's financial institutions were encouraged to fund risky and unprofitable ventures. In a banking system, where state-owned banks play a significant role, bureaucratic interference is likely to be a serious problem. Government officials could, and did, direct loans to favored firms activities. In addition, the close link between banks and some of the conglomerates further reduced the likelihood that loans would be objectively evaluated. Even when government pressure was absent and when banks did not engage in intra group lending, loans were rarely subjected to even the most rudimentary economic and financial analysis. In part, such analysis was handicapped by the absence of disclosure requirements and accounting standards that would allow analysts to make a reasonable estimate of risk. And in part political pressure was exerted on bank regulators so that they would not report some of the most flagrant violations of the banking laws.

In July 1997, the economy was overheated, marked by a rapid increase in money supply and inflation. Money supply (M) increased by 25%. To handle the situation back in control, the government tried to implement some tight money policies: contraction of bank credit by increasing the interest rate through monetary instruments (Central Bank of Indonesia). The following short list of statistics show the situation during the first hit of Indonesia's financial crisis.

	Domestic	Foreign
Interest rate	18-22%	5-8%
Inflation	5-9%	2-4%
Money supply (MO)	Rp. 50-70 trillion	-
MI per December 31, 97	Rp. 300 trillion	--
Exchange rate depreciation	4-5% p.a.	floating
Exchange rate band	6% (up & down) p.a.	floating
August 1997	Floating	

Leaving aside non-economic factors, it was absolutely cheaper to borrow money from foreign sources. Thus, private sectors made foreign debt with commercial requirements and short term (1-2 years) return. They only paid interest with interest:

Sibor + x% with a calculation that forex rate band of the central bank (Bank of Indonesia) that was controlled for 4-5% for rupiah depreciation to US\$. These private sectors used the debts for long-term businesses, such as property and golf course that have long-term return. In addition to this, they invest in rupiah currency for long term investment for the debt in US Dollar. As the implication, the flow of foreign capital was increasing enormously, amounting to about 84 BUSD only within three years, compared to government debt amounted to only 54 BUSD in 30 years.

In such a situation, financial institutions fail in their function, to serve as an efficient intermediary, channeling savings to their most productive use. It is of course true that all investments have associated risks. But when savers, whether domestic or foreign, have no real capacity to evaluate the risks, the real cost of capital will be overvalued and the returns on investment overstated. As a result, scarce funds will be allocated to low-return, high-risk activities. By the time, global market had expected that short-term loans increased rapidly; that only within a year had surpassed government debt. The possibility of a default was high.

Second, when neither investors nor lenders expect to bear the full cost of any failure, they will lower their guard against risky investments. This is what the term "moral hazard" means. Moral hazard describes a situation where, in the presence of a perceived implicit or explicit guarantee, there is little incentive to avoid risky behavior. It is true that the government of Indonesia never extended any explicit guarantee against bank or corporate failures. But it is also true that the involvement of well-connected parties in many of our economic activities generated a feeling that, to quote a line from a popular American movie, "failure was not an option here." Unfortunately, in the end, failure was very much an option here. Actions by government and the central bank further encouraged the popular belief that Indonesian banks would not be allowed to fail.

Thus, when the government supported a recapitalization of World Bank in 1990, provided support to Bank Danamon to stem a bank run in 1991, and in 1994 made good the losses suffered by BAPINDO, it inadvertently suggested to all that banks would be protected from failure. As Paul Krugman noted, such implicit guarantee can trigger asset price inflation, reduce economic welfare, and ultimately make the financial system vulnerable to collapse.⁴

In a similar vein, foreign exchange regime also encourage risky behavior. Although Indonesia did not peg its exchange rate, as did some other Asian countries, we did maintain a managed float within a relatively narrow band. Borrowers judged that the expected loss from currency depreciation was less than the cost of hedging their foreign borrowings. For many years, this proved to be correct. The consequent mispricing of foreign credits contributed to the very large capital inflows and created Vulnerability for companies with substantial foreign exchange exposure. When we were forced to abandon our managed float, the depreciation of the rupiah created unmanageable debt burdens that effectively bankrupted a substantial portion of the corporations.

Added to this situation was political side of the financial regime. Unchallenged for three decades, Suharto personalized the state's power. His words, however vague (Suharto usually uses round-the-circle phrases) became unwritten laws. Personalization of political power structure was so deep that he himself controlled almost everything, including economic policies. Centralization of power more in the sense of Personalization of state's structure resulted in a king-like style of administration. Suharto then was not distributing his power; he was "franchising" the state power to those whom he liked.⁵ Holders of the franchise were not limited to those who occupied political positions but also to individuals and certain groups who controlled economic resources; unfortunately, Suharto gave preference to his long-time Chinese business partners and his own family rather than distributed more justly among various other economic actors.

In return, Suharto provided political patronage for those who held the "franchise." In many cases, a political patronage was enough as a credit guarantee; even some foreign lenders put a confidence on this political tie. A good example is the case of Peregrine, a financial institution in Hongkong that agreed to give credit to Steady Safe taxi company in Jakarta--Suharto's daughter, Siti Hardiyanti Rukmana, better known as Mbak Tutut, owned some shares of this taxi company--several times its real assets. Used as "easy money", the fund was channeled to various investment, mostly in building toll roads. When the exchange rate rose sharply, the company could not pay off its debts, resulting in Peregrine's bankruptcy. For three decades, Suharto's power was based on the "political of shared growth."⁶ By maintaining a successful economic performance, he managed to effectively use pieces of the "development pie" as political resource. Yet, with a fragile political-economic structure, it was then only a matter of time that the economy would collapse.

III. The Multiple Crises and its Implications

On January 25, 1998, Chairman of the Indonesia Chamber of Commerce (KADIN) announced that private sectors could not repay their foreign debts. Debt Equity: Ratio (DER) of private sectors at the time --when the exchange rate was only 1\$ = Rp.2,300. was 7 : 3. In January 1998, Private DER already reached 30:3. Lenders refused the debtors' inquiry for roll-over; instead, they asked the debtors to immediately pay their debt in due time. The situation following Thailand's monetary crisis made the private short-term overhang.

As a direct impact of this situation, the demand for foreign currency, especially the US dollar, increased, making rupiah plunged further. Central Bank's intervention could not successfully prevent rupiah's drop to US Dollar so that the exchange rate band (ranging 6% to 12% per annum) was abolished to make it floating. Rupiah's exchange rate to US Dollar plunged further, increasing the uncertainty. Under this uncertainty that foreign and domestic speculators started to react. Those who did not need US Dollar were to buy dollar and those who had dollars would not sell their money because the exchange rate was continuously to dive. This created a situation where the demand for foreign currencies was higher than the available currencies. Some bought ~~for foreign~~ for speculation and some others, such as importers and freight forwarders, needed the currencies badly.

Following Thailand, Indonesia had then have no choice other than to ask loans from IMF. In October 1997, the two parties reached a deal. However, the government did not consistently implement the deal. Just to mention two examples, the government revived 15 out of 81 blue book projects and several of the closed banks. In turn, this triggered public's confidence crisis. Manifestation of this confidence was, among others, people rushed to buy nine basic commodities (popularly known as "sembako, sembilan bahan pokok"). Some of these commodities were missing from markets; if they were available, prices rose two or threefold. In January, exchange rate of 1\$ was already rising above Rp. 8.000.00, almost threefold of its previous value.

By the end of December 1997 and early January 1998 the situation was completely out of control that IMF felt the need to bring another additional proposal. On January 15, the then President Suharto signed this proposal, known as the second Letter of Intent. In this proposal, IMF applied a generalized model and prerequisites for restructuring the banking system, some of which produced social

costs as side effects. For example, the requirement for liquidation of "unhealthy banks" was done without any signs so that people were caught in social costs such as massive layoffs. IMF also applied fiscal reforms and tight money policies (TMP) that required high interest rate and cutting off development projects, all of those had a deep impact on the people's political psychology.

In general, IMF's recipe turned out to be a hopeless cure, although economists had reminded that inconsistent policies the government still pursue were mostly responsible for the failure. Two other examples of these inconsistencies were the stubborn attitudes of the government to maintain the so-called national car project named Timor and the monopoly over the clove (an important ingredient for "kretek" cigarette) business; Tommy, Suharto's youngest son, ~~who~~ controlled both the businesses. Frustrated with the worsening financial crisis and disappointed with the IMF's "failure" Suharto started to look for other possible venues. To the surprise of many economists, he announced the possibility of applying a fixed exchange rate system through the establishment of a Currency Board System, or CBS. Critiques amounted to the plan, Suharto sought support by manipulating a political parlance, that "IMF's plan is not in accord with the 1945 Constitution." He indeed gained some political support, but the decline of value of the rupiah was unstoppable. Only after some heated public debates, the plan was dropped.

In early 1998 critics of the government had warned against possible eruption of people's discontent over the ways Suharto gave privilege for his family and friends. There was a growing resentment among the people over news about the president's family businesses. Yet, Suharto in particular and members of the elite in general, including members of the cabinet, had no sense of crisis. "They run business as usual," said critics. Under such a situation, Suharto made a series of erratic decisions. As has been stated earlier, he succeeded in personalizing the state, making his failure as the government's failure. Yet, there is no doubt that his erratic decisions were a sign of the end of an authoritarian government.

Factual implications of what figures in macro economies brought to the society in general can be seen from what happened since January 1998. The first serious hit of the financial crisis took place in the first week of December 1997, when rupiah plunged beyond the "psychological barrier" of 1\$ = Rp.5.000. However, it hit the business class first and the middle class to follow. Average distribution chain allows 3-4 weeks before the actual blows reaches the commoners. This was what happened. Since

the first week of January, and escalating through the second and third weeks of January 1998, riots started to spark in many rural areas in Java and various places outside Java as well.

Throughout February, the situation was calmer. Several reasons played a role, two are most imminent here. First, there was an adjustment process. People were angry when they could not buy as much as what they used to get with the same amount of money. In various instances, they run amok; thus, the riots broke, although still sporadic and in small scale. After a while, however, they started to adjust to the new situation, that their purchasing power was now declining sharply.

Second, the People's General Assembly (MPR) was to be in session in early March. Among one of the agenda was that the Assembly would elect the new president and vice president. Previously, on January 19 1998, Suharto had officially announced his will to run for another term, his seventh consecutive five-year term in office. His decision means that he should be elected, at all cost. The authorities had made it clear that anyone who was trying to disturb political stability would face a severe measure. This was an implicit threat to any group or political power trying to stop Suharto's ascendancy to presidency.

In order to clear up the pathway for the general session of the Assembly, the military deployed a full-scale operation. Tanks and other armed vehicles were stationed at strategic spots surrounding the parliament's building, troops were at every corner of the streets. Jakarta was guarded by about 30 thousand troops, two fold of the figure in "normal" condition. The situation was so tense that it looked like the city was about to enter a battle in a war. The deployment was taken as an anticipation against possible demonstrations to the parliament. Combined forces of threat and adjustment seemed to be effective, at least for some time and on surface. Underneath, however, the economic and political heat was at a boiling point. Suharto was elected and sworn as president on March 11, 1998; he had chosen Habibie for the vice president. Many, especially political activists who were fighting against Suharto, were frustrated. But the political upturn was not followed by an economic recovery. Dollar was fluctuating between Rp. 12.000 and Rp. 15.000, making it even more impossible for debtors to pay their due debts. As stated earlier, the people only felt the impact of the rupiah's drop 3-4 week later. The ever more fluctuating dollars then hit the bottom of the society severely for the first quarter of 1998.

University students were not exempted by the crisis. As Indonesia experienced a long tradition of student movements, now the students moved again. Most of the best tertiary education are state universities or subsidized by the government, a situation to grow a feeling that students must pay off their "debts" by voicing the people's consent. The number of students going to the streets is enormous. There was a common scene that in one student demonstration they could gather to tens of thousand. Their message, to demand a total reform, became clear with a single interpretation ; asking Suharto to step down.

In the second week of May, confident that the country was safe enough, Suharto was away to visit some countries in the Middle East. But it turned out that May 12 was a decisive ; it was a turning point for Suharto's fate. On that day, four Trisakti University's students were fatally shot. The next day, riots started to spark in West Jakarta, followed by riots in all six major cities throughout the country. The result was devastating, thousands of people were killed during the riots, let alone its physical damage. The riots have deep social and political impacts, irreparable even for many years to come. The economic crisis was now inseparable from social and political crises.

Politically, the riots brought some serious political dislocations. The ruling elite, Suharto included, who was previously running the administration as if no crisis was taking place, was now aware that they could not hide away but to face the crisis. Suharto was then forced to meet a popular demand to reshuffle his cabinet and to form a Reform Council, which he himself chaired. His proposal was too late ; most of the names he asked refused to be appointed. Meanwhile, since May 18, the students occupied the parliament building. Mounting pressure was unbearable for Suharto; he stepped down from his presidency and endowed the seat to Habibie on May 21, 1998.

The "succession" was not an end to the crisis. Many believe that there was indeed a leadership, but not a regime's change. Political format that Suharto had laid down and strengthened for over thirty years is too solid to be replaced in that short period of time. Today's political situation is too complex to expose and predict. Thus, let me concentrate more on the economic policies that will be more conceivable to take in the future. Although it seems that the tunnel of the crisis still has no end, at least for the near future, there is still some hope to overcome it. The questions then; what policies will allow us to overcome the crisis, and equally important, what policies must we avoid ?

IV. The Future : Some Possibilities

Managing the impact of the economic crisis calls for a range of policies, but laying the foundation for recovery calls for a narrower set of actions. First, and most obvious, we must strengthen our financial institution. While financial reform is often considered a long-run issue, in the current economic situation reducing the vulnerability of our financial sector is a short-run problem. Investor confidence cannot be restored until we can assure investors, foreign and domestic, that the banking system is sound. If investors face the risk of a sudden and massive reduction in their final wealth, it is obvious that they will be reluctant to invest money in Indonesia.

But the problem is more complex than just it looks. Having lost confidence, we must now be able to provide investors with assurances that the risk of a future financial crisis has been sharply reduced. This means that we must establish effective supervision of our banks and other financial institutions. The rules under which our banks should operate are well established in law. What is now needed is effective supervision that will ensure that the laws are impartially implemented and that those violations of regulatory rules will be made public and effectively dealt with. Lending must be based on a professional and objective assessment of costs and potential benefits, free from outside interference.

Second, we must implement measures that will mitigate moral hazard. Bank failures will occur and since bank failures have the potential of creating systemic risks, government cannot treat the failure of a financial institution as it would treat corporate bankruptcy, an issue to be settled without government interference. But how government deals with problem banks is important. When banks are found to be in difficulty prompt corrective actions are needed. Any delay in imposing disciplinary actions will only encourage banks to engage in desperate last minute actions to try to salvage a bad situation. Numerous examples provide ample evidence that such efforts create even greater risks and generally lead to larger loss.

It is also important that bank managers be made to bear a substantial part of the cost of bank failures. Even where government provides deposit insurance, so that depositors are given some protection against bank failures, bank owners and managers must lose their investment when banks fail. And finally, bank supervision, in our case the staff of Bank Indonesia, must give public accounting for the failure of banks

under their supervision. While these steps will not eliminate the impact of moral hazard, they will sharply reduce it.

What actions should the government not take ? Here I would only mention two. First, the current crisis has an unleashed backlash against open capital accounts. Numerous arguments are being put forward for exchange controls. I had assumed that the question of whether capital controls were an effective exchange rate management tool had been laid to rest, but it appears I am wrong. The recent crisis has brought forth a variety of suggestions for capital controls, carefully tailored so that it will target only short-term capital movements that are assumed to be highly volatile.

This is understandable. But the evidence on the effectiveness of capital controls is weak. It is sometimes asserted that measures such as those employed by Chile, perhaps the most famous example of supposedly successful controls, can work to reduce the proportion of short-term and portfolio capital relative to long-term and equity investment. But a careful reading of Chile's experience suggests that such controls work only in the short-run, if they work at all. Over the longer term, capital controls have been shown time and time again to reduce the level of capital inflows, thus reducing investment growth. They appear to have little effect on the real exchange rate or on the current account.⁷

Second, and not unlike the issue of bank supervision, our capital markets must also become more transparent and better regulated. Companies wishing to be listed on our exchange must adhere to international accounting standards. This will allow potential investors to have reasonable basis by which they can evaluate the health of the company in which they are investing. Given the absence of sound, transparent, and internationally recognized accounting standards, investors will continue to rely on other indicator of likely success, including political connections and government support. If we truly wish to have a capital market that will attract funds to productive investments, we must ensure that the information needed for rationale decision making is available.

The economic crisis has damaged our corporate sector and our financial institutions. Most critically, the crisis has destroyed the confidence the markets had in the management of our economy. Confidence is hard to define until it is lost. Regaining confidence of the international financial community will not be easy. But

it must be done. Without a resurgence of confidence we will not see a return flow of foreign capital, portfolio as well as direct investment. Access to such funds provided critical inputs for our economy. It is understood, that capital bring in also modern technology and management. The absence of capital will in turn reduce investment, hence growth, and will retard the modernization of our economy. The answer is not to prevent capital inflows : the answer is to ensure that our financial institutions and our capital markets are capable of effectively mediating such capital.

No one should doubt the severity of the current economic crisis. Yet, neither should anyone underestimate our capacity to set our institutions right. The "Asian economic miracle" was not a mirage ; it was real. And many of the factors that allowed Indonesia to grow by over 7% per annum for over a decade are still there: strong infrastructure, a well-disciplined labor force, and ample natural resources. These are the elements that will power our growth in the future. But before that happen we must rebuild our financial institutions so that they are capable of performing the functions that a modern economic state requires : to mobilize capital and effectively channel it to its most productive use.

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- ¹ A paper presented before a seminar on "The Relation Between the European Union and Indonesia in the Context of the Asian Crisis," organized by Clingendael Institute in cooperation with the Institute for Strategic and International Studies / Lisbon, The Hague, October 26-27, 1998 .
 - ² See for example, "Asia Financial Crisis Lesson and Responses," Ramon Moreno, Gloria Pasadilla and Eli Remolona Working paper # PB98-02, Economic Research ..
 - ³ See, for example, Jeffrey D. Sachs and Steven Radelet. "The Onset of the East Asian...
 - ⁴ Paul Krugman,
 - ⁵ I borrow the term coined by Laksamana Sukardi, a former banker turned politician, in one of his interviews with the press.
 - ⁶ R. William Liddle, *Leadership and Culture in Indonesian Politics* Sydney. Allen & Unwin, 1996 pp 37-62.
 - ⁷ Capital Flows and Exchange Rates in the Pacific Basin "Federal Reserve Bank of San Francisco, Economic Research Department, Number 98-22 (July 17, 1998).