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INDONESIA: THE ECONOMIC CRISIS 1997-1998

by

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This paper provides a short study of Indonesia's economic performance before July 1997 and an early diagnosis of the economic crisis in Indonesia, which occurred from July 1997 to March 1998. After achieving remarkable economic development success over the past several decades, Indonesia unavoidably had to face economic difficulties. What are the causes of economic crisis? To answer this question is the purpose of this paper. The paper finds that the combination of several factors contributed to the economic crisis, the factors are: Thailand's economic crisis; contagion/spillover effects; Indonesia's structural weakness, debt and crisis of confidence; globalization and integration within the financial/capital market; investors and panic-stricken lenders; speculative attacks; socio-political factors, drought, forest fires; and foreign exchange rate regimes.

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INDONESIA: THE ECONOMIC CRISIS 1997-1998

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Submitted in partial fulfillment of the
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ABSTRACT

This paper provides a short study of Indonesia economic performance before July 1997 and an early diagnosis of the economic crisis in Indonesia which occurred from July 1997 to March 1998. After achieving a remarkable economic development success over the past several decades, Indonesia unavoidably had to face an economic difficulties. What are the causes of economic crisis? To answer this question is the purpose of this paper. The paper finds that the combination of several factors contributed to create the economic crisis, the factors are: Thailand's economic crisis; contagion/spillover effects; Indonesia's structural weakness, debt and crisis of confidence; globalization and integration within the financial/capital market; investors and panic-stricken lenders; speculative attacks; socio-political factors, haze and drought problems; and foreign exchange rate regimes.

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I. INTRODUCTION

A. BACKGROUND

For the past 20 years, a growing number of countries in Southeast Asia have consistently recorded some of the highest rates of economic growth in the world. The high growth performers in these countries have grown at 6-8 percent per annum. This growth was accompanied by improvements in a number of social indicators, suggesting that social welfare was rising throughout the region. We are accustomed to studying the reasons for the success of the so-called Asian Tigers in Southeast Asia, and these economies have been the envy of the rest of the world. Currencies were stable, stock markets skyrocketed, and domestic growth was constantly among the highest in the world. This outstanding performance is well above that experienced in other developing countries.

Until a few months ago (July 1997), growth almost came easy. As a region, Southeast Asia grabbed the opportunities of "globalization" and translated them into levels of dynamism found almost nowhere else on earth. Large capital flows stimulated these countries, and they benefited somewhat from globalization.

But now, the globalization brings serious challenges. Since July 1997, Southeast Asian exchange rates have been volatile, stock markets slump, and foreign investors are now cautious, the region is at a crossroads. The Southeast Asian economies have been plunged into a crisis far more severe than anyone predicted. The financial crisis was sparked by the sharp depreciation of the Thai bath, which in turn triggered similar downturns in the Philippine peso, Malaysian ringgit, Indonesian rupiah and even the Singapore dollar. The crisis happened not only in Southeast Asia but also spread to other regions, such as Hong Kong and South Korea. The crisis spread around the region as foreign investors sold out, and local companies scrambled for hard currency to cover their debt obligations. The IMF was forced to bail out Thailand and Indonesia and, most sensationally of all, South Korea. For Indonesia, this has been the biggest financial crisis ever, since the new order took the power in 1965. After a growth rate of 7% per annum for the past 20 years, the Indonesian government has to face these financial difficulties. How and why did this happen? The purpose of this thesis is to answer these questions.

B. OBJECTIVE

The objective of this thesis is to answer the following questions:

- What happened with the Indonesian financial system in 1997-1998?
- Why the financial crisis happened in Indonesia?
- What was the Indonesian economic situation before the crisis?
- What are the causes of the financial crisis?
- How has the Indonesian government faced the crisis?

C. SCOPE AND LIMITATION

1. Scope

This thesis will focus on the financial crisis in Indonesia and will address the Indonesian economic condition before the crisis. It will present and review the situation during the crisis, how the government faced the crisis and the causes of financial crisis in Indonesia.

2. Limitation

This thesis will only examine the financial crisis during a nine-month period, starting in July 1997 to March 1998. What happens after this period is another matter and may give different results needing further research.

D. METHODOLOGY AND LITERATURE REVIEW

1. Methodology

The information necessary to complete this study was gathered by reviewing available literature from books, magazines, newspapers, the Internet and other library information resources. The first step was to review the articles concerning the crisis in Indonesia, and Southeast and East Asia. Secondly, to collect data, and third to analyze the data.

2. Literature Review

The majority of the literature reviewed included information provided by the Naval Postgraduate School

Library, course outlines and the Internet. The list of references is properly documented and appropriately footnoted in List of references.

E. DEFINITIONS AND ABBREVIATIONS

There are numerous definitions and abbreviations that are used in the text of this thesis. A consolidated glossary, including all definitions and abbreviations, is contained in Appendix A.

F. ORGANIZATION OF STUDY

The remaining three chapters provide the details of the research conducted. Chapter II begins with Indonesian past performances. Indonesia's successful performance and recent development (before July 1997) was derived in this chapter. Chapter III addresses the financial and currency crisis in Indonesia from 1997-1998. This chapter provides the indication and the unfolding of the crisis in Indonesia, episodes from July 1997 to March 1998. Chapter IV analyzes the causes of the financial and currency crisis. Finally, Chapter V contains the summary, conclusions, and recommendations for further research.

II. PAST PERFORMANCES

A. SUCCESSFUL PERFORMANCE[1]

The Republic of Indonesia has achieved remarkable economic development success over the past several decades and is considered to be among the best performing East Asian economies. Designated as one of the 10 "Big Emerging Markets" by the U.S. Department of Commerce[2], this nation is abundantly endowed with natural resources and a population of 200 million. Prudent macroeconomic policies, high investment and saving rates, and continuing structural reforms to liberalize markets have kept Indonesia on a path of rapid economic development.

Since the 1970s, economic growth has averaged 7% per annum, raising GDP per capita toward the level of middle income countries, while dramatically lowering the incidence of poverty. The economic structure has become diversified, as dependency on the oil sector has declined and an export-oriented manufacturing base has emerged, led by a dynamic private sector and fueled by high domestic savings and large inflows of foreign direct investment. Meanwhile, macroeconomic balance has been maintained; the budget has been balanced; inflation has been contained at relatively low levels; current account deficits have been kept moderate; and international reserves have remained at comfortable levels.[3] According to the World Bank in an

[1] See Figure 2.1, 2.2, 2.3, and Table 2.1, 2.2.

[2] Edward C. Schultz, Dynamic Indonesia Economy leads Asia Pasific Region, www.solusinet.com/econ02.htm.

[3] Business news, Economy in 1998, www.indonesiatoday.com.

Indonesian country brief, Indonesia grew at a rate of 7.1% between 1985 and 1995, and attained a real Gross Domestic Product (GDP) growth of 7.8% in 1996. The benefits of this growth have extended across all of Indonesia's 27 culturally diverse provinces.

Between 1970 and 1996, the proportion of the population living below the official poverty line declined from 60% to an estimated 11%, reflecting the government's strong commitment to poverty reduction. All provinces have increased income, consumption, and employment, although they have done so at different rates and starting from different levels. The quality of life for the average Indonesian has improved significantly. Infant mortality declined from 145 per 1,000 live births in 1970 to 53 per 1,000 in 1995, while in the same period, life expectancy rose from 46 to 63 years. Indonesia has achieved universal primary education, reduced the adult illiteracy rate by nearly two-thirds, and significantly increased the percentage of the labor force with a secondary or tertiary education from 11.7% in 1980 to 29.3% in 1994. Indonesia has also succeeded in reducing the wage and educational gaps between males and females. Few countries in the world can match Indonesia's narrowing of gender differentials across all levels of education.[4]

"Indonesia can be justifiably proud of its development record. Twenty-five years ago, it was one of the poorest countries in the world, with a per capita income of only $50. Since then, it has made great strides, achieving an average GDP growth of almost 7% per annum, a growth performance that ranks among the ten fastest in the world and on part with that of the dynamic East Asian economies, which rose at a rate of about 4.5% p.a. Over this period, Indonesia's per capita income reached $650 in 1992 and $1,130 in 1996, implying a substantial improvement in living

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[4] The World Bank Group, Indonesia, country brief.

standards. Indonesia is still classified as a low income country, but, provided the momentum of development is sustained, it is now within striking distance of joining the ranks of middle income countries."[5]

[5] The World Bank, Indonesia-Sustaining Development, p.2, Washington D.C., January 1994.

Table 2.1 The Indonesian Economic Trends

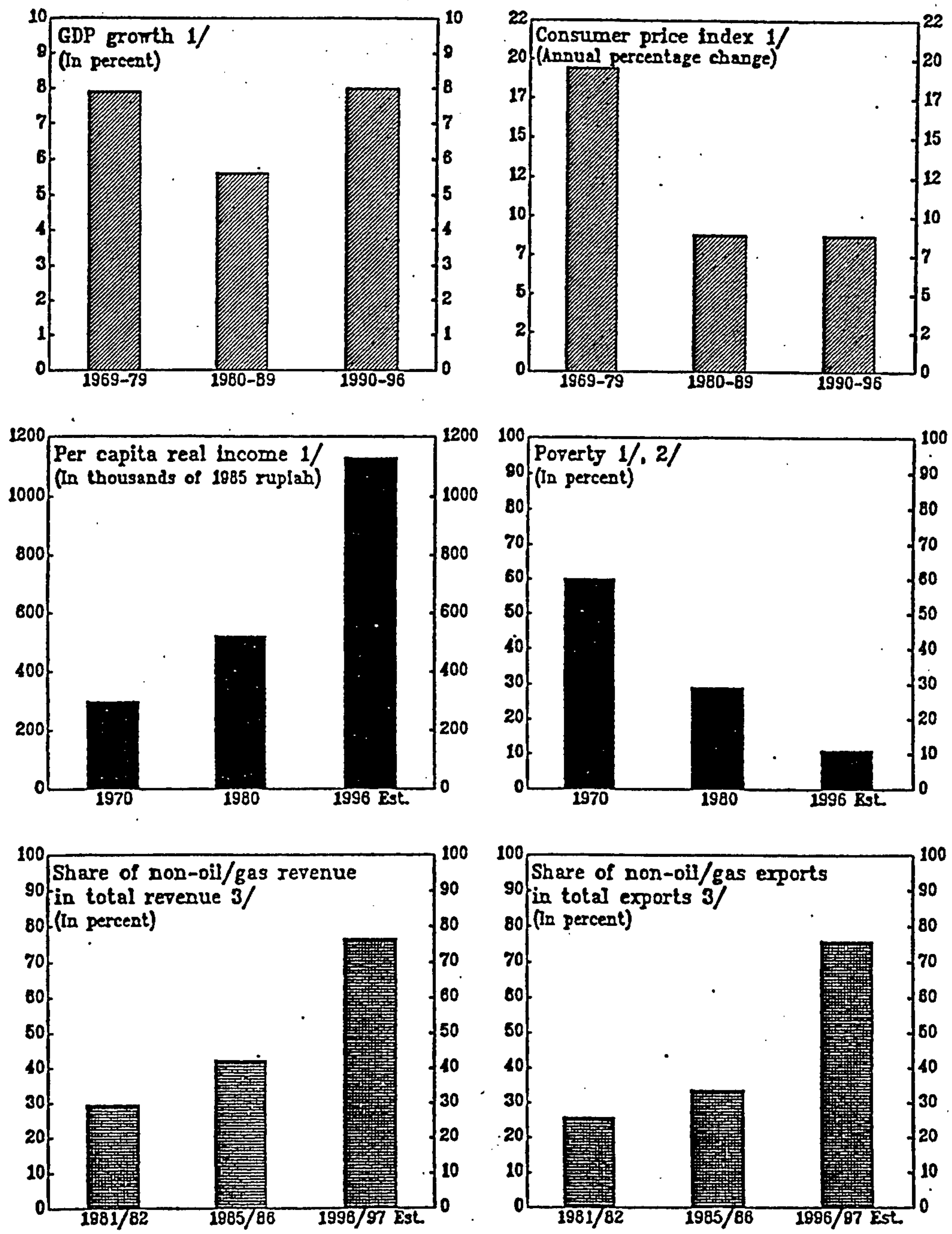
	1994	1995	1996	1997	1998p)
1. The growth rate of GDP (% p.a.)	7.5	8.1	7.8	4.7	0
- GDP per capita (US$)	920	1,023	1,184	910	330
- GNP per capita (US$)	886	978	1,047	875	300
2. Total export (US$ bill)	40.0	45.5	49.8	55.2	59.5
Total increase (%)	*9.2*	*13.8 r)*	*9.5*	*10.8*	*7.8*
Non-oil/gas(US$ billion)	31.4	35.2	38.1	42.5	45.7
Non-oil Increase (%)	*15.8*	*12.1*	*10.4*	*11.5*	*7.5*
3. Total import (US$ bill)	-32.0	-39.8	42.7	-44.6	53.5
Total increase (%)	*13.9*	*24.4*	*7.8*	*4.4*	*20.0*
Non-oil/gas(US$ billion	-29.6	-36.0	-39.7	40.5	48.2
Non-oil increase (%)	*20.8*	*21.6*	*9.2*	*2.0*	*19.0*
4. Current account (US$ bill)	- 3.0	- 6.8 r)	- 7.8r)	-6.9	-8.5
5. Foreign exc.res.(US$ bill) (End of the year)	13.2	14.7	19.1	20.5	n.a 1)
6. Total money supply (Rp bill)	45,622	52,677	64,089	68,062	n.a
Increase in 12 months(%)	*23.1*	*15.5*	*21.7*	-	*n.a*
7. Bank credit (Rp billion)	188,575	234,611	292,921	402,351	n.a
Increase in 12 months(%)	*27.1*	*24.4*	*24.8*	-	*n.a*
8. Comm. bank deposit (Rp bill)	170,406	214,764	281,718	350.738	n.a
Increase in 12 months(%)	*19.4*	*26.0(e)*	*31.2*	-	*n.a*
9. Average interest rate (% p.a.)					
a. 3 months time deposit					
-State bank	10.8	15.0	14.6	17.0	n.a
-Private bank	15.4	18.0	17.6	28.7	n.a
b. Short-term credit					
-State bank	15.5	16.9(e)	16.9	21.0	n.a
-Private bank	18.6	20.5(e)	20.2	31.9	n.a
10. Inflation rate, % p.a	9.24	8.64	6.47	11.05	40(*

Notes : r) Revised figures
e) Estimate by Data Consult
p) Projection figures
n.a. = data not available
1) The government is considering to apply Currency Board System (CBS)
Source: Bank Indonesia, Central Bureau of Statistic and Data Consult

Table 2.2 Indonesia: Social and Demographic Indicators, 1969-97

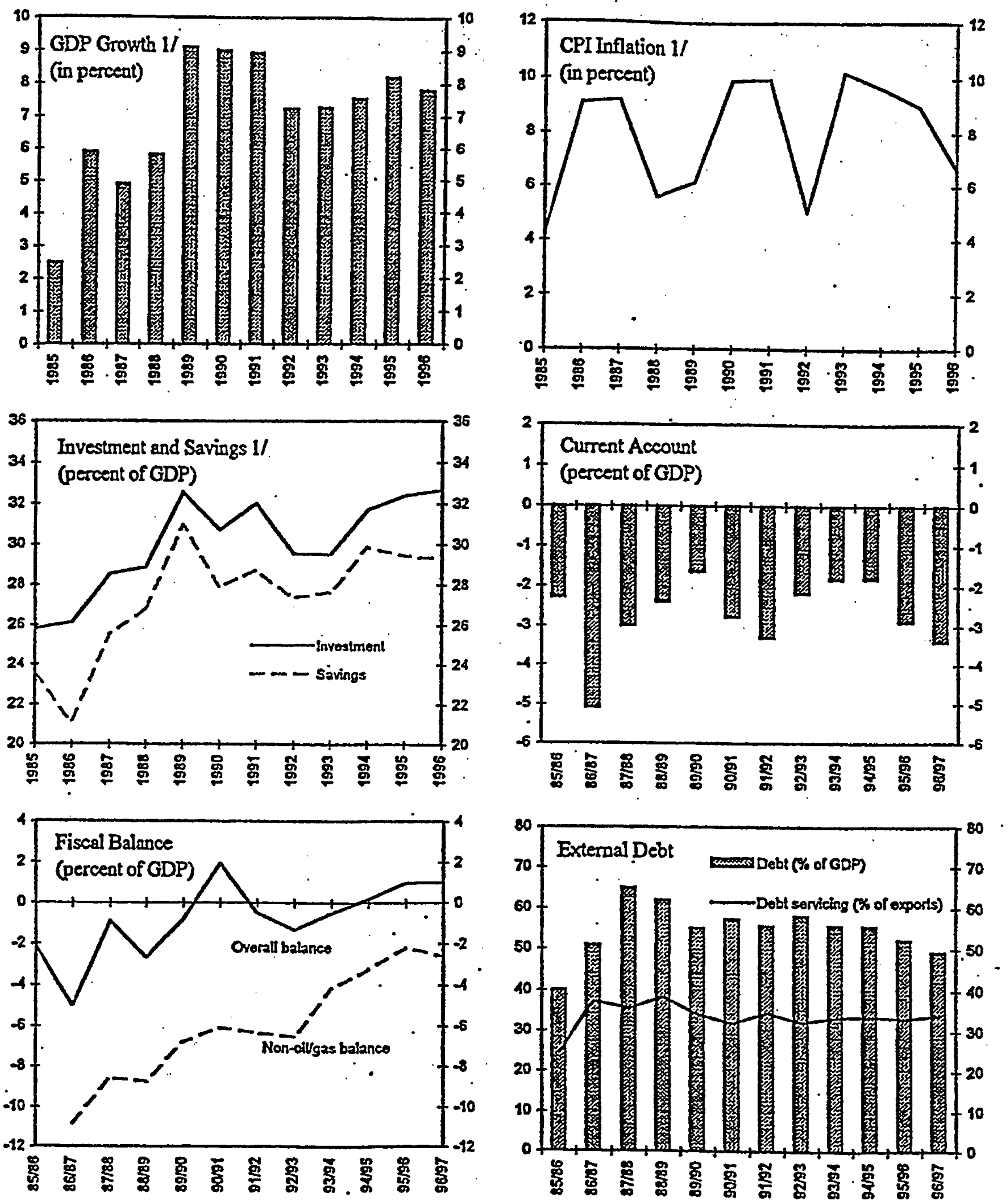
	Unit of Measurement	Fifteen to Twenty Years Ago	Most Recent Estimate
Natural resources			
Area	Thousand sq. km.	1,905	1,905
Agricultural land	Percent of land area	21	25
Forests and woodland	Thousand sq. km.	1,222	1,095
Access to safe water	Percent of population	11	42
Rural	Percent of population	4	32
Urban	Percent of population	41	65
Human resources			
Total population	In millions	133	200
Urban population	Percent of population	19	34
Population growth	Percent per annum	2.4	1.6
Urban population growth	Percent per annum	4.8	3.6
Life expectancy at birth	Years	51	63
Infant mortality rate	Per thousand live births	114	53
Labor force (ages 15-64)	Millions	52	88
Health and education			
Population per physician	Persons	26,988	7,028
Population per hospital bed	Persons	1,222	1,503
Primary school enrollment	Percent of school-age group	86	114
Secondary school enrollment	Percent of school-age group	20	43
Pupil-teacher ratio: Primary	Pupils per teacher	29	23
Secondary	Pupils per teacher	16	16
Illiteracy rate (age 15 plus)	Percent of population	43	16
Income and poverty			
GDP per capita	U.S. dollars annually	210	1,130
Share of top 20 percent	Percent of income	52	41
Share of bottom 20 percent	Percent of income	7	9
Population below poverty line	Percent of population	29	11

Sources: World Bank, Social Indicators of Development 1996; and staff estimates.



Sources: Data provided by the Indonesian authorities; and staff estimates.
1/ GDP, inflation, and poverty data refer to the calendar year.
2/ Poverty is defined as the share of the population living below the official poverty line.
3/ Fiscal year begins April 1.

Figure 2.1 Development and Structural Indicators



Sources: Indonesian authorities; and staff estimates.
1/ GDP, inflation, investment, and savings data refer to the calendar year.

Figure 2.2 Selected Economic Indicators

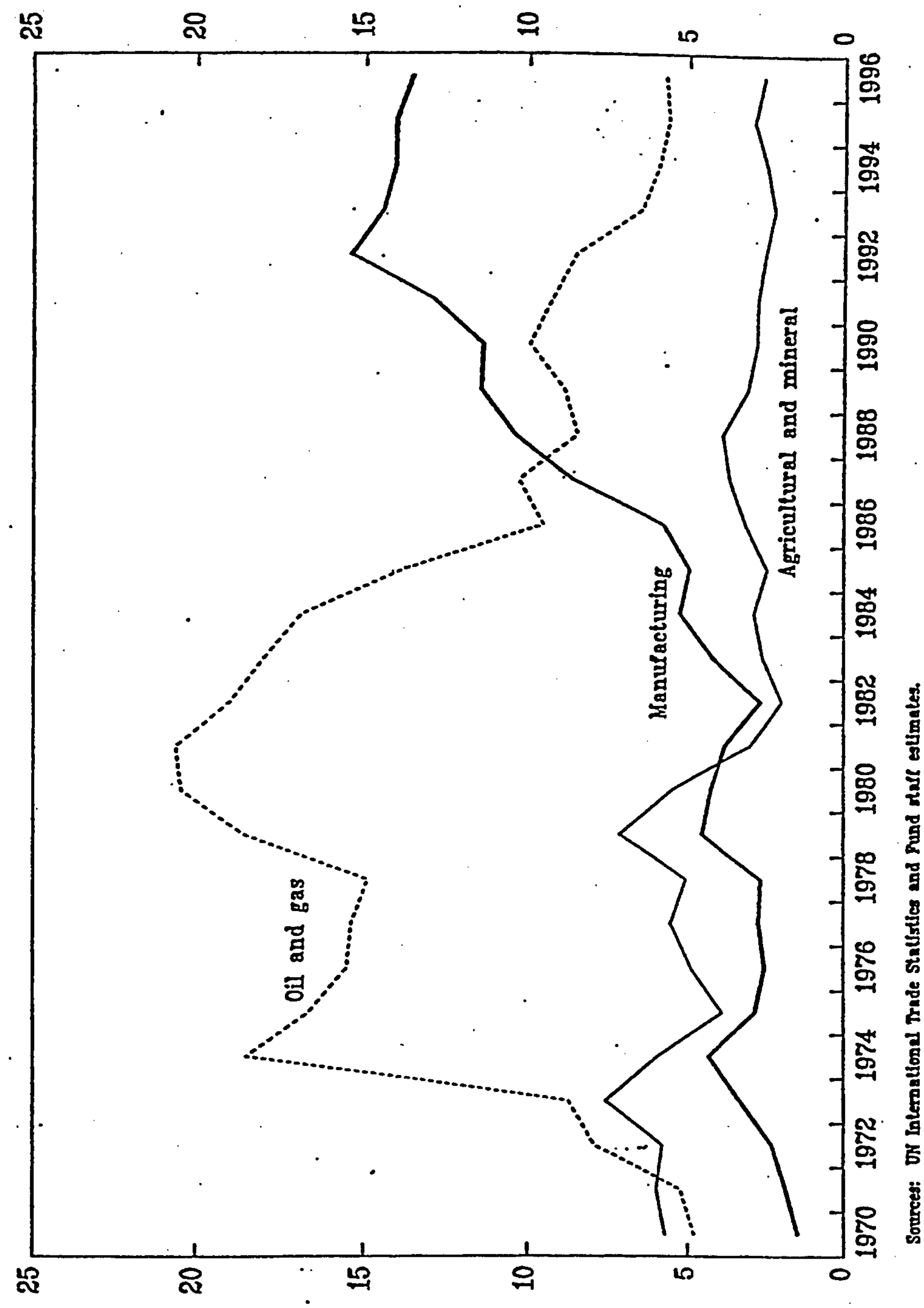


Figure 2.3 Changing Shares of Exports

B. RECENT DEVELOPMENTS (BEFORE JUNE 1997)

The Indonesian economy continued to perform well in 1996 and in the first quarter of 1997, with real GDP growth of 7.8% in 1996. The rate of inflation fell to 5% in 1996/1997, assisted by improved food supplies and generally subdued import prices. The Consumer Price Index in June 1997 declined by 0.17%, resulting in a decade low 2.54% cumulative year-to-date inflation rate, far below the 4.03% recorded for the first semester last year. A budgetary surplus of 1% of GDP for 1996/1997 reflected higher-than-projected oil revenue and firm expenditure control.

The external current account deficit widened to 3.5% of GDP in 1996/1997, although it remained below that in most ASEAN countries, it was largely financed by short-term inflows of portfolio capital. Export growth moderated to 9% in U.S. dollar terms (7% in volume terms), despite an above normal contribution from the oil sector. While Indonesia was less affected than other Asian countries by the downturn in the world demand for electronics, the performance of the labor-intensive footwear, garment, and textile sectors weakened because of competition from lower-wage economies, including China and Vietnam.

Capital inflows remained large, but foreign investment approvals in the first quarter of 1997 fell by 30% year-on-year. Foreign investment approvals through May dropped by 25.5% to US$13.7 billion from US$18.3 billion due to election-related concerns, according to the Minister of Investment, Sanyoto Sastrowardoyo. Official reserves increased to the equivalent of six months of imports in 1996/1997. The Minister of Information, Harmoko, said in April that foreign exchange reserves, as of April 1997, had reached US$20.38 billion.[6] A more flexible exchange rate

[6] Indonesian Business: The Year in Review 1997.

policy was adopted to help deal with the capital inflows; the central bank intervention band was widened three times from 2% to 8% between January and September 1996. While the authorities continued to depreciate the band against the U.S. dollar, the nominal effective exchange rate of the rupiah appreciated because of the strength of the dollar against other major currencies.[7]

1. Real Sector[8]

a. Output and Expenditure

The Indonesian economy had grown by 7.8% in 1996, slightly below the 8.2% increase recorded in 1995. Non-oil/gas GDP rose by 8.5%, while the oil/gas sector made a small positive contribution of 0.9%. Private consumption and investment both expanded rapidly, although net exports made a negative contribution to GDP. The economy's potential output was increased by 7-8% a year, reflecting the relatively high and well-directed investment. Overall, the economy has continued to operate at close to its productivity capacity.

(1) Aggregate Demand. Real domestic demand growth was nearly 9% in 1996, slower than the very rapid expansion in 1995, but similar to the average rate of growth for this decade. Total real consumption increased by 8.5% in 1996, with government consumption rising by 4% and private consumption by 9%. The strong consumption growth has caused national savings to stabilize in relation to GDP.

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[7] IMF, Indonesia-Recent Economic Developments, September 1997.

[8] See Figure's 2.4, 2.5, 2.6.

Total real investment increased by 12% in 1996, reaching almost 33% of GDP. Investment in machinery and equipment rose by 22%. Investment in buildings and structures, representing three-quarters of capital formation, increased by 12%, with property investment growing much faster than the total. Domestically financed investment approvals rose by over 40% above the record level of 1995.

Foreign investment approvals reached the highest level recorded, after adjusting for the extraordinary approvals of petrol-chemical refineries in 1995. Large investments were approved in resource-based manufacturing (chemicals, basic metallic industries, and paper products), hotels, and public utilities. Actual foreign-financed expenditure increased by one-fifth, and comprised about 10% of the total gross investment.

On a national account basis, the external trade balance weakened in 1996. Exports of goods and services (in constant prices) slowed to 6%, compared with 9% in 1995, partly because of weaker demand in Indonesia's main markets. Competitiveness factors dampened sales of textiles, footwear, and wood products. Imports of goods and services (in constant prices) grew by 10%, also slower than the rise of 15% in 1995. The slowdown reflected smaller growth of consumer goods, especially food and raw materials. However, imports of capital goods continued to grow rapidly.[9]

(2) Sectoral Developments. The diversification of the Indonesian economy has helped sustain rapid growth and provided resilience against weaknesses in

[9] IMF Staff Country Report No.97/75, Indonesia-Recent Economic Developments, p.9-10,Washington D. C. September 1997.

individual commodity markets. The manufacturing sector, accounting for one-fourth of GDP, provided the largest sectoral contribution to overall growth. Non-oil/gas manufacturing output increased by 12%. On a sectoral basis, GDP growth was slow and the main reason was the agricultural sector performance, which comprised 16% of GDP. The growth rates of other sectors were very similar to those recorded in 1995. The production of agriculture, fishing, and forestry increased by 2% in 1996, on top of the recovery in 1995. The production of rice increased by 1.5%. Rice prices increased by 6% in 1996 compared with 15% in 1995 and 21% in 1994. Production of cassava, copra, palm oil and fisheries all showed increases. Mining and quarrying output increased by 7% in 1996. The output of gold, coal, and nickel continued to increase, but growth in copper production was lower. With oil/gas production essentially stable, other mining products constituted over one-third of mining output or 3% of GDP.

b. Development Plan

Substantial progress was made in 1996/97 toward achieving the government's macroeconomic objectives set out in the sixth five-year Development Plan (1994/95-1998/99). The main targets of that plan are real GDP growth at 7.1%; annual inflation at 5% or less; GDP for the external current account deficit at 2%; gross international reserves equivalent to 6 months of imports; annual growth in non-oil exports at 17%; an investment share in GDP at 30.5%; non-oil budget revenue reaching 16.9% of GDP, with non-oil taxes equal to 13.7% of GDP; and public debt declining to 30% of GDP by the end of the period.[10]

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[10] IMF Staff Country Report No.97/75, Indonesia-Recent Economic Developments, p.10-11. September 1997.

Real GDP growth in 1996/97 exceeded the target and its average growth by almost 8% during the first three years of the plan. Per capita income has risen by around 6% per year while inflation has declined to the targeted level during 1996/97. The level of domestic investment has exceeded the target; foreign financing has also been higher than the targeted investment. International reserves strengthened sharply to their target level, and public debt has fallen below the target.

In other areas, the achievement of macroeconomic objectives has been somewhat less successful. Non-oil export growth fell below the targeted level after being close in the first two years. Non-oil budget revenue has leveled off to 11-12% of GDP. The current account deficit has risen beyond the target range, although the overall external position remains strong.

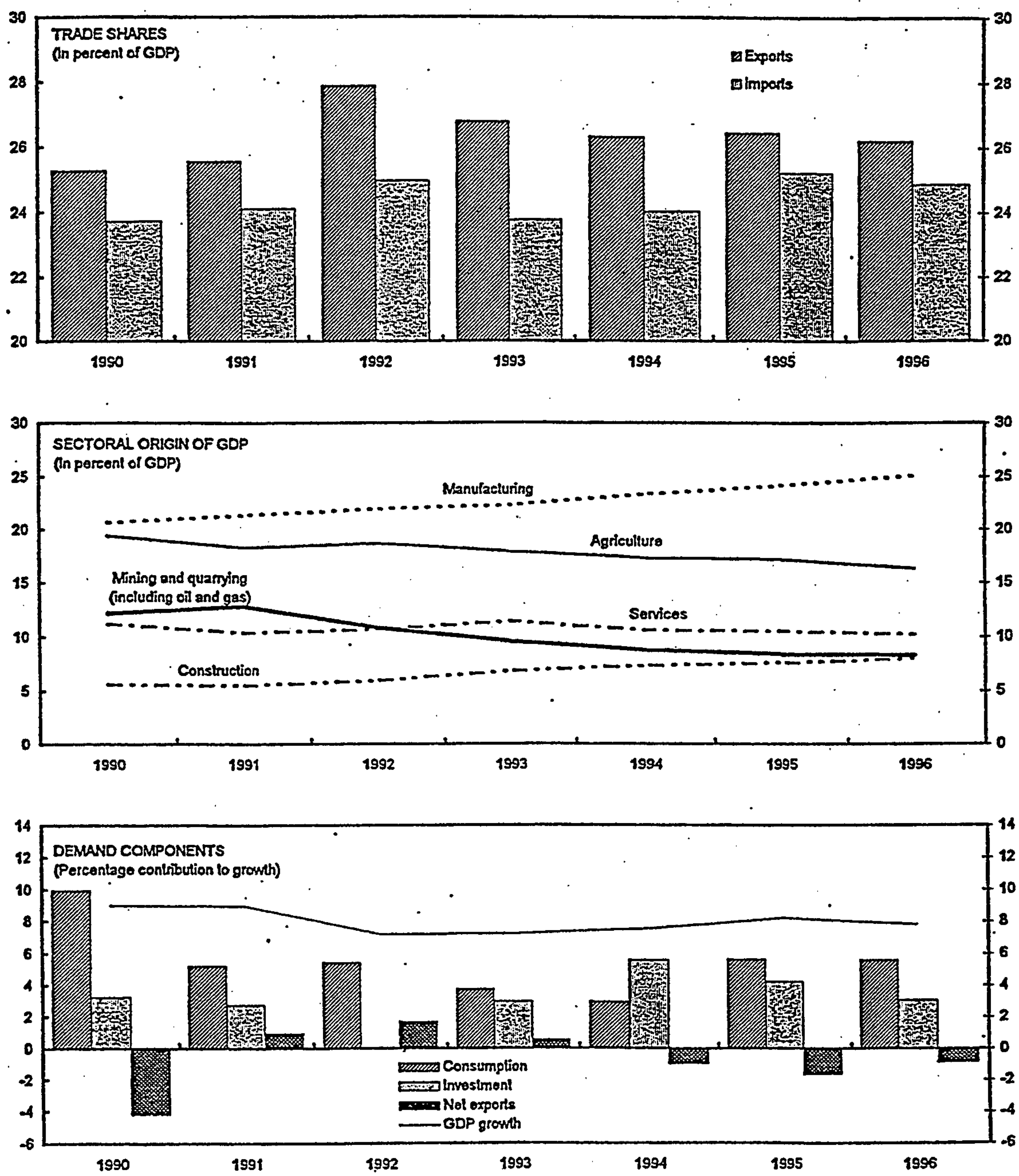
(1) Prices and Wages. The inflation rate was 6.6% for December 1996, but the rate declined to 5.3% for the year ending March 1997. Food prices increased by 6.1% in 1996, but only 3.8% over the fiscal year, as supply conditions improved. Non food price inflation remained around 7%. Public transportation, electricity, and telephone charges were raised during 1996; fertilizer and unhusked rice prices were increased in February 1997. Domestic petroleum prices have remained unchanged since 1993. Wholesale price inflation was 7.7% in 1996, lower than the previous year. Agricultural prices rose by 11%, while manufacturing prices increased by only 2%, conforming to the moderation of domestic cost pressures. Wholesale import prices rose by 3.4%, while wholesale export prices increased by 20%, entirely due to world oil/gas price movements.

(2) Minimum wages increased by about 9% in April 1996, but the effective increase was much larger because of the concurrent change to determining monthly wages for daily workers on the basis of 30 paid working days rather than 25 days. In April 1997, the government announced a further average minimum wage increase of 10.4%. Minimum wages were considered to be broadly sufficient to meet basic needs.[11] The Minister of Manpower, Abdul Latief, said that companies that could not afford to pay the wage increase could submit appeals to the government. The government, however, would check on the company's fundamentals before extending the deadline.

In May 1997, the government raised the Civil servants' monthly salaries by 34.4% for those on the highest grade and by 73% for those on the lowest grade. Civil servants are classified into four grades: I, II, III, and IV with each grade divided into four strata: a, b, c and d except grade IV, which has five strata: a, b, c, d and e. The lowest strata are I-a and the highest IV-e. Indonesia has around four million civil servants.[12]

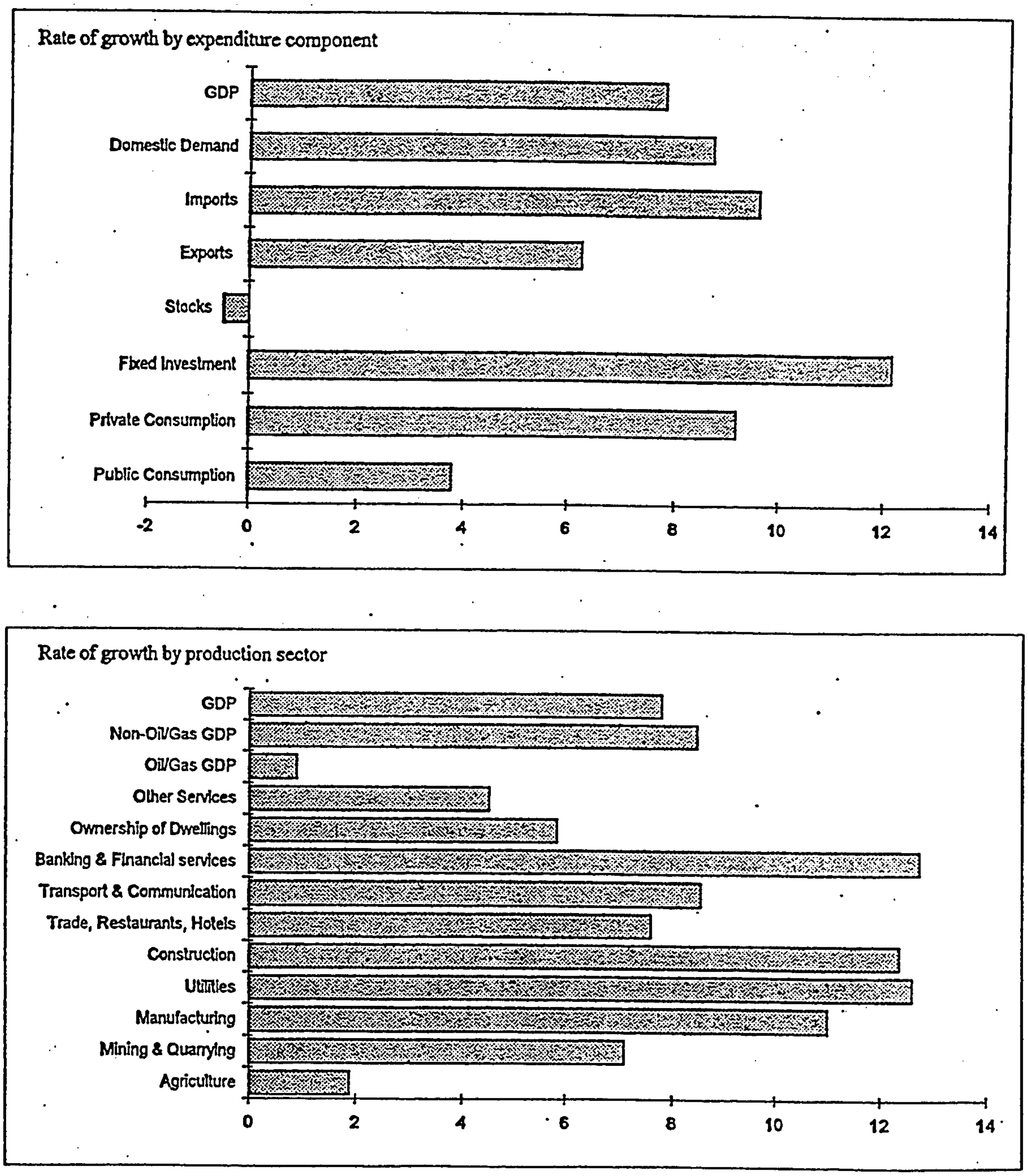
[11] IMF Staff Country Report No. 97/75, p.12.

[12] Indonesian Business: The Year in Review 1997, Chapter 2, Macro Economic Indicators, The Castle Group Business Information.



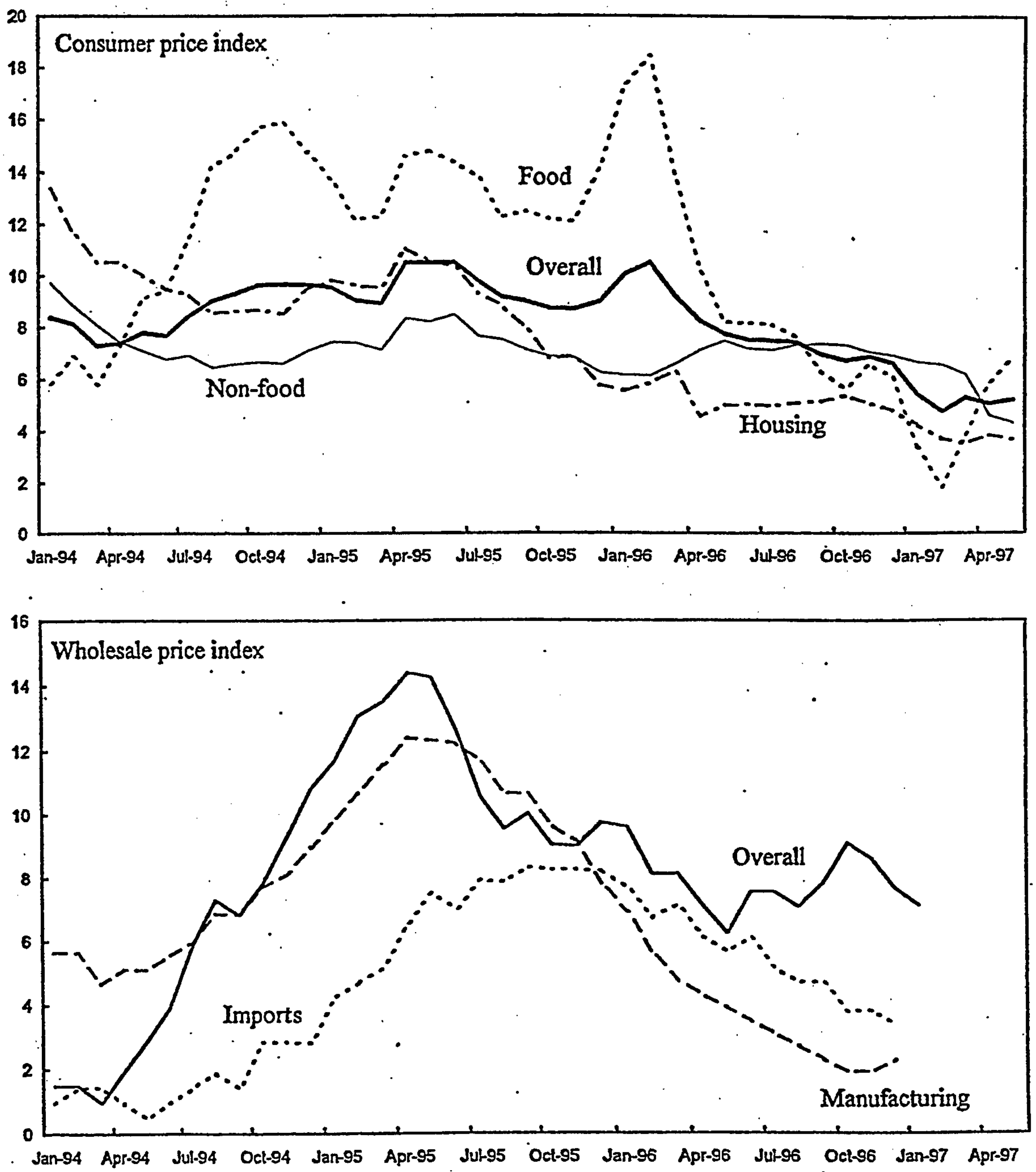
Source: Data provided by the Indonesian authorities.

Figure 2.4 Real Sector Developments, 1990-96



Source: Data provided by the Indonesian authorities.

Figure 2.5 GDP Growth, 1996



Source: Data provided by the Indonesian authorities.

Figure 2.6 Inflation, 1994-1997

2. Public Finance[13]

a. *General Situation*

Indonesia's public sector consists of the central government, 27 provincial governments, 368 municipal and local governments, and some 170 public enterprises. Central government transfers account for more than one-half of regional government revenue. A large share of public enterprise investment has been funded by loans from the central government, mainly in the form of foreign borrowing undertaken for that purpose.

Consolidated public sector accounts are not prepared officially and published information does not enable them to be constructed. Central government budget data indicate small surpluses in recent years, although details of spending through off-budget accounts are incomplete. Provincial government transactions appear to be in approximate balance. However, the inclusion of quasi-fiscal activities and operations of public enterprises would probably indicate an overall public sector deficit.

Central government revenue and grants have averaged 15-16% of GDP in recent years. Oil/gas revenue has accounted for about 3-4% of GDP compared with 10% of GDP one decade ago. Non-oil/gas revenue has stabilized at 11-12% of GDP. Current expenditure has remained at about 9% of GDP, while development expenditure and net lending has fallen to about 6% of GDP, partly reflecting greater private sector participation in infrastructure. As a consequence of the improvement in the fiscal balance and continued strong output growth, external public debt has steadily declined to less than 30% of GDP.[14]

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[13] See Figure 2.7.

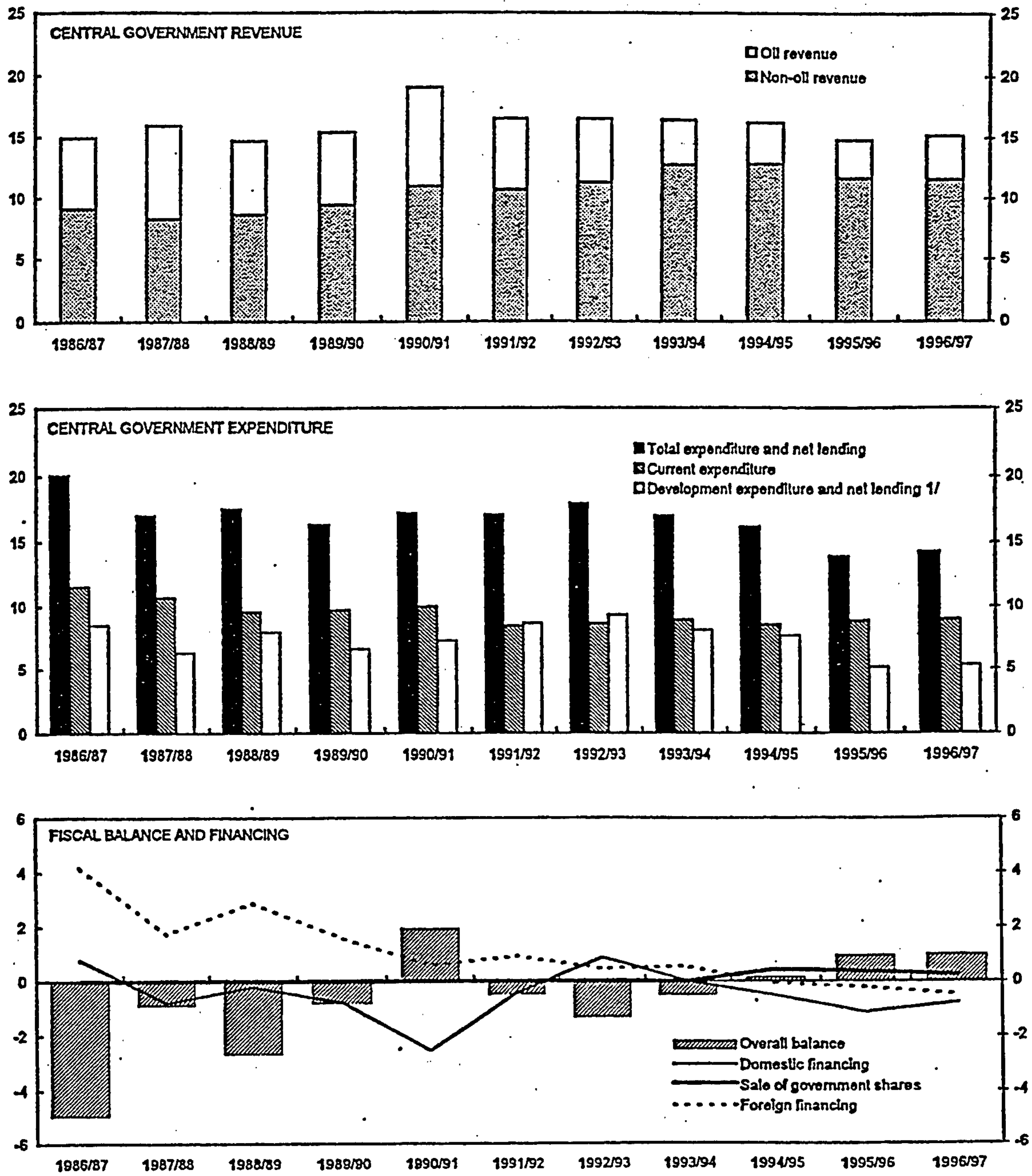
[14] IMF Staff Country Report No. 97/75, p. 13-14.

b. Central Government Finances

Total revenue (including grants) in 1996/97 amounted to Rp75.7 trillion (15% of GDP), exceeding the original budget estimates by about Rp5.5 trillion. Revenue from the oil/gas sector increased by nearly one-third. Non-oil/gas tax revenue increased by 19%, in line with budget estimates. Non-oil/gas income tax collections increased by 24% to Rp25.5 trillion (5% of GDP), well above budget estimates and equivalent to one-third of total tax revenue. Value-added tax revenue increased by 11% to Rp20.4 trillion (4% of GDP), and accounted for 27% of total tax revenue. Excise taxes grew at about the same rate as nominal GDP. Taxes on international trade declined to the equivalent of less than 4% of total revenue, well below the budget projection.

Nontax revenue rose by 17% to Rp7.7 trillion (1.5% of GDP). Bank Indonesia met its target, despite the cost of exchange market interventions. Total expenditure and net lending increased by 19% to Rp78.5 trillion (14% of GDP), almost equal to budget estimates. Current expenditure reached Rp49.2 trillion (9% of GDP) with personnel costs increasing by 17%, in line with the budget. Development expenditure and net lending increased by 12% to Rp29.3 trillion (under 6% of GDP), somewhat below budgeted levels. Net foreign financing of the budget was negative for the third consecutive year (0.5% of GDP). This reflected the use of privatization receipts of Rp1.4 trillion and the fiscal surplus to prepay relatively expensive external debt of Rp4 trillion. Domestic financing was also negative (0.5% of GDP), as the central government surplus permitted a further buildup of deposits in the banking system.[15]

[15] IMF,Staff Country Report No. 97/75, p. 14-15.



Sources: Data provided by the Indonesian authorities; and staff estimates.
1/ Derived from the sum of the current balance and net financing.

Figure 2.7 Fiscal Indicators, 1986-97
(In percent of GDP)

3. Financial Sector[16]

a. *Banking Sector*

The financial system is dominated by the banking sector. Rapid economic growth, a liberal capital account regime and regulatory changes over the past decade have all contributed to fast changes in Indonesia's banking sector. During the period of 1988-1994, the number of commercial banks increased from 111 to 240. Since then, the increase of minimum capital requirements from Rp10 billion to Rp50 billion has reduced the number of potential entrants, leaving the number of institutions almost constant over the past four years. The seven state banks dominated the sector, with their combined assets accounting for about 45% of the entire system, although their share of total lending has declined markedly in recent years.[17] The private commercial banks have grown faster than the state banks, which accounted for about 30% of the total banking system assets in mid-1997. There were also 9,300 rural banks, which are limited in the geographical area of operations and in banking activities. The nonbank financial sector, including savings banks, mutual funds, pension funds, insurance companies, and leasing companies, has continued to develop.

The return on assets of commercial banks averaged 1.2% and the return on equity over 16% in 1996, which exceeds the rates of profitability in many comparable countries. Large private sector banks were generally well

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[16] See Figure 2.8, 2.9, 2.10, 2.11.

[17] Anne-Marie Gulde, Banking Sector Challenges, Indonesia-Selected Issues, IMF Staff Country Report No. 97/76, September 1997, p.54.

managed and competitive, but the soundness of the banking system, especially for the state banks and smaller banks, has been of concern. Foreign currency borrowings showed substantial growth between 1988 and 1996, foreign currency deposits have also grown rapidly, but banks' foreign currency liabilities were generally higher than their foreign currency assets. Although Bank Indonesia imposes limits on net open foreign exchange positions equivalent to 25% of bank capital, a small number of banks did not always comply with this rule.[18]

The average share of nonperforming loans (those classified as substandard or doubtful) has declined consistently over the last three years from over 14% in December 1993 to about 8% in December 1996. For state banks, the average share of nonperforming loans remains high at over 15%. The average capital adequacy ratio of the banking system had reached 12%, but several banks have not met the 8% minimum ratio. A number of banks continued to violate legal limits on loan-to-deposit ratios and lending to connected parties. There had been a rapid expansion in lending to the property sector, which accounted for 20% of total outstanding loans in February 1997, compared with 12% at the end of 1993.

With signs of easing growth, the Bank Indonesia cut rates by 0.5% in December 1996, and again by 0.5% in March 1997, hoping to moderate the inflows of capital, ease the debt burden on struggling Indonesian firms, and allow an increase in exports.

[18] Anne-Marie Gulde, Banking Sector Challenges, Indonesia-Selected Issues, IMF Staff Country Report No. 97/76, September 1997, p.54.

In the meantime, the Indonesian firms were still borrowing very heavily in international capital markets.[19] For these circumstances, Bank Indonesia had taken further steps to strengthen the soundness of the banks. Efforts had been intensified to improve compliance with prudential regulations, including ensuring that bank supervisors had sufficient authority to undertake the comprehensive and timely evaluation of bank assets. Bank Indonesia had placed greater emphasis **on moral suasion** to restrain overall credit growth, including the increasing use of limits for individual banks based on their level of capital and the riskiness of their lending portfolios.[20]

In March 1997, Bank Indonesia Director Hendrobudiyanto said that the central bank would impose administrative sanctions on banks breaching their credit growth limit. The statement marks a significant change in Bank Indonesia's policies, since previous credit growth limit was enforced merely by moral suasion, not real sanctions. Bank Indonesia Governor, Sudradjad Djiwandono, summoned bankers telling them that total credit growth in 1997 would be limited to around 17-18%. For some banks, this meant that targets were set for 18-20% credit growth while for some larger banks, those with assets exceeding Rp5 trillion (US$2.12 billion), credit growth would be set at only 13%. Total outstanding credits in the Indonesian banking sector rose 24.6% to Rp292,92 trillion (US$121.44 billion) in 1996 after growth of 24.2% in 1995, according to Bank Indonesia statistics.

Bank Indonesia, the central bank, has secured a US$500 million standby loan from 40 international financial

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[19] Giancarlo Corsetti, Paolo Pesent, Nouriel Roubini, What caused the Asian currency and financial crisis, March 1998, p.58.

[20] IMF, Staff Country Report No. 97/75, p.17-18.

institutions to back up the country's foreign exchange reserves. The standby facility has a tenure of eight years. The loan carries an annual interest rate of 0.625% above the London Inter Bank Offered Rate, should the government draw down the loan. The facility carries a commitment fee of 0.3125% per year. The lead arrangers included Commerzbank Ltd., Fuji Bank Ltd., Industrial Bank of Japan Asia Ltd., NatWest Markets and JP Morgan Securities Asia Ltd. Indonesia's foreign exchange reserves currently stand at US$19 billion.

In April 1997, Bank Indonesia toughened restrictions on foreign borrowings by on-shore banks. The measure is designed to maintain prudent debt management to prevent further stresses on the balance of payments and to ensure adequate capacity for future debt repayments. The latest regulation requires banks to allocate at least 80% of their foreign borrowings of more than two years maturity as credits to export-oriented industries. The regulation also requires banks to submit annual foreign borrowing plans to the central bank (Bank Indonesia) and to report on the amount of foreign loans they receive. Foreign borrowings by banks are limited to a maximum 30% of their capital base. Foreign banks will be required to allocate a minimum of 20% of their credits to small borrowers, and the central bank, Bank Indonesia, will fine foreign banks which fail to comply with this regulation.

Indonesia's bad loans rose in April 1997 to 2.93% (of total extended debts of Rp349.7 trillion) up from 2.8% in December 1996, but lower than the 3.29% recorded in December 1995, stated Bank Indonesia. Total outstanding loans in April were Rp349.7, compared to Rp331.2 trillion in December 1996 and Rp267.8 trillion in December 1995. Property loans, as a percentage of total loans, rose to 19.61% in April 1997, up from 12.2 in December 1992. Bad debts in the property sector rose 39.2% from the end of 1996 to US$1.9 billion in the first quarter of 1997. However, more than 90% of loans to the property sector are still classified as problem free. The property sector's cumulative debts, as a proportion of total banking credit, increased from 18.8% at the end of 1996 to 19.6% in the first quarter of 1997. Officials and property analysts noted that most property projects utilize short-term loans to finance development.[21]

b. Monetary

Recent financial market developments have been dominated by the buoyancy of foreign capital inflows, both direct investment and portfolio flows, which have boosted monetary and credit growth. This limited the ability of the authorities to reduce inflation and gave rise to upward pressure on the exchange rate. The authorities have continued to set targets for monetary and credit growth, in accordance with the objective of reducing and maintaining inflation at around 5% per anum, as outlined in the five-year development plan. However, concern about exchange rate appreciation and external competitiveness has, in practice, led to reduce emphasis on monetary targets.

Over the last two years, targeted and actual growth rates for broad money and private sector credit have diverged. Broad money increased by nearly 27% in 1996/1997, slightly lower than 1995/96, but well above the official target of 17%. The growth of quasi-money was 29%, including rupiah time and savings deposit, as well as foreign currency deposits. Reserve money grew to 14% in 1996/97. Private

[21] *Indonesian Business: The Year In Review 1997, The Castle Group Business Information, Chapter 1, Capital Markets, Banking and Finance.*

sector credit growth accelerated to almost 24% in the year to March 1997 compared with the official target of 16%.

Interest rates remained relatively high in real terms during 1996/97, as the authorities sought to restrain monetary growth. The authorities were able to reduce the rate gradually to just under 11% by March 1997 and still increase their sales of certificates because of the decline in domestic price inflation. Three-month deposit rates at private national banks declined from 17% in the fourth quarter of 1997 to 16.3% in May 1997. Rates on bank advances for working capital were in the range of 18-20%, and rates on investment loans remained broadly unchanged at 16.5%.[22]

c. *Exchange Rate*

During 1996, in the face of the strength of private capital inflows, the Indonesian authorities had increased nominal exchange rate flexibility to enhance the effectiveness of monetary policy. The authorities had to widen the exchange rate intervention band on three occasions; first in January from 2% to 3%, second in June from 3% to 5%, and third in September from 5% to 8%. On each occasion, the rupiah moved to the appreciated end of the band immediately following the change. Bank Indonesia slowed the pace of depreciation of the nominal rupiah/U.S. dollar exchange rate to 3.5% in January to March 1997, whereas in the previous year, the rupiah had depreciated by 5.6%. This was the response to the persistent upward pressure on the exchange rate stemming from capital inflows.

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[22] *IMF Staff Country Report No, 97/75, Indonesia-Recent Economic Development, p. 18-19.*

Movements in the real effective exchange rate (measured by relative consumer price inflation vis-à-vis trading partner countries) were also influenced by the U.S. dollar/Japanese yen rate, but most of the appreciation of 7.6% in 1996/97 stemmed from the slower nominal exchange rate. From a slightly longer-term perspective, the appreciation of the real effective exchange rate since the middle of 1995 effectively reversed much of the depreciation that occurred in 1994-95, as a result of the strength of the Japanese yen vis-à-vis the U.S. dollar.[23] In June 1997, the IDR/USD market was remarkably strong, appreciating by 0.2% for the month, or by 2.2% on an annualized basis, while Bank Indonesia depreciated the middle rate by 4.4% on an annualized basis in June 1997.

d. Capital Market

In 1996, market capitalization of the Jakarta Stock Exchange increased by over 40% to Rp215 trillion (40% of GDP). Higher stock prices, the index rose by 24% over the year, accounted for over one-half of the increase in capitalization, with the remainder due to new issues and an expansion in the number of companies listed on the exchange. The number of listed companies increased from 248 to 267 during 1996. The activity of the domestic bond market increased markedly, with new issues raising over Rp11 trillion, an increase of over 26%. Mutual funds expanded their operations rapidly, the number of mutual funds increased from only one in 1995 to 18 at the end of 1996, which collectively mobilized Rp1.9 trillion.

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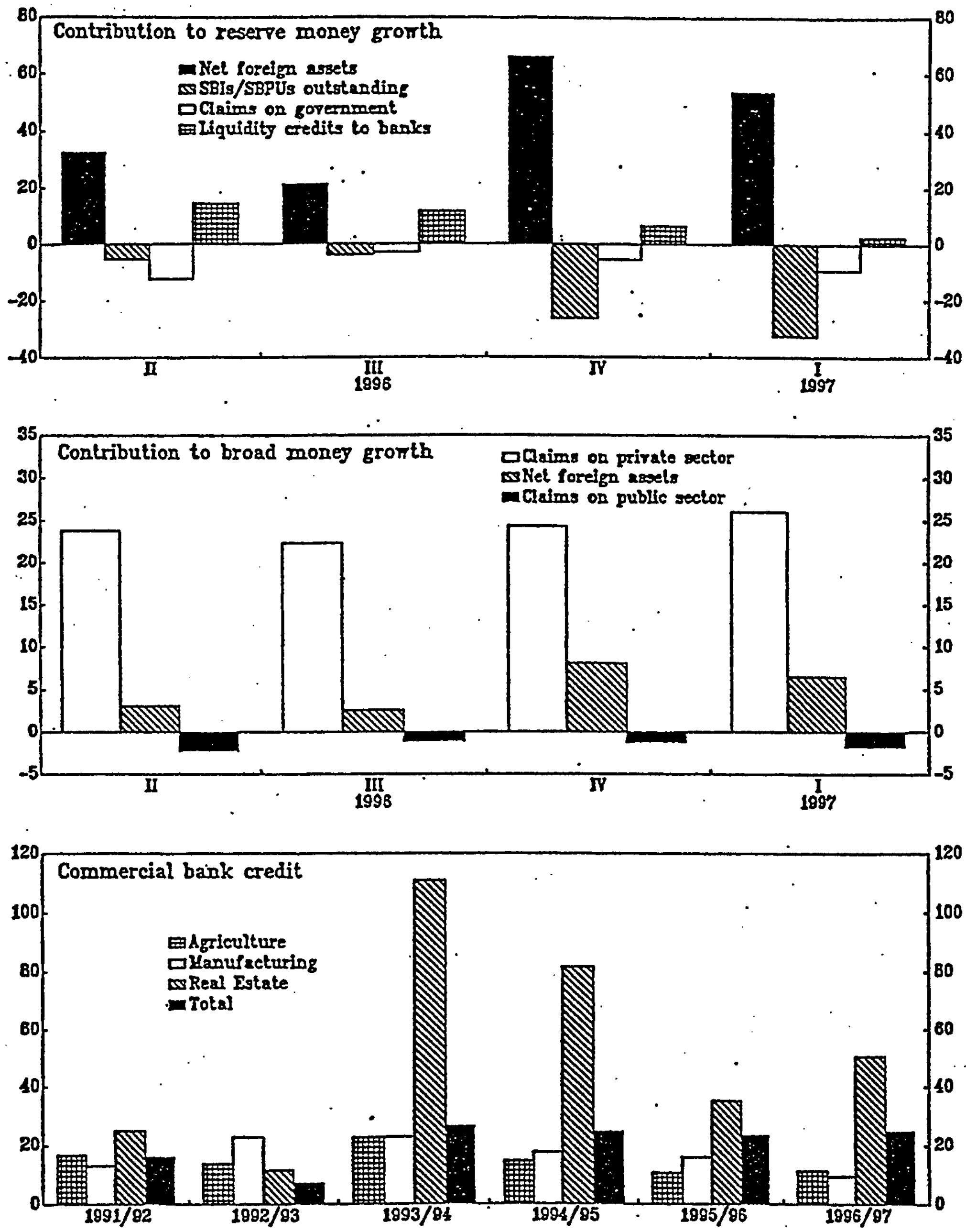
[23] *IMF Staff Country Report No, 97/75, Indonesia-Recent Economic Development, p.19-20.*

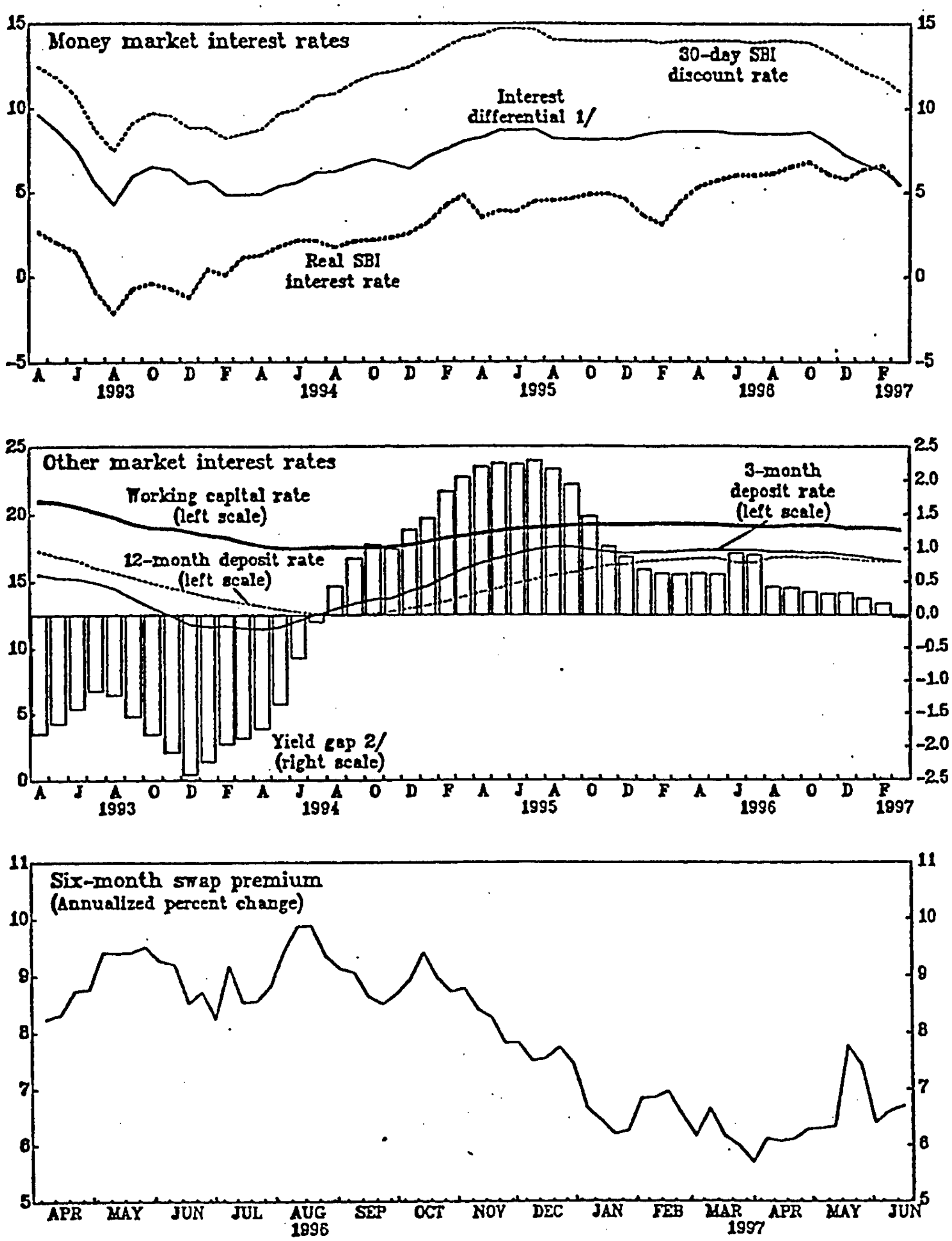
Market sentiment remained strong throughout most of the year, except during July-August when political uncertainties contributed to a sharp downturn in share prices. Share prices continued rising during most of the first half of 1997 and reached new record levels following the parliamentary elections in late May 1997, with the index about one-third higher than at the beginning of 1996.[24]

[24] IMF Staff Country Report No, 97/75, Indonesia-Recent Economic Development, p.20.



Source: Data provided by the Indonesian authorities.

Figure 2.8 Money and Credit Growth, 1991/92-. 1996/97



Sources: Data provided by the Indonesian authorities; and IMF Information Notice System.
1/ 30-day SBI interest rate less LIBOR.
2/ 3-month interest rate less 12-month interest rate.

Figure 2.9 Monetary Conditions, 1993-97

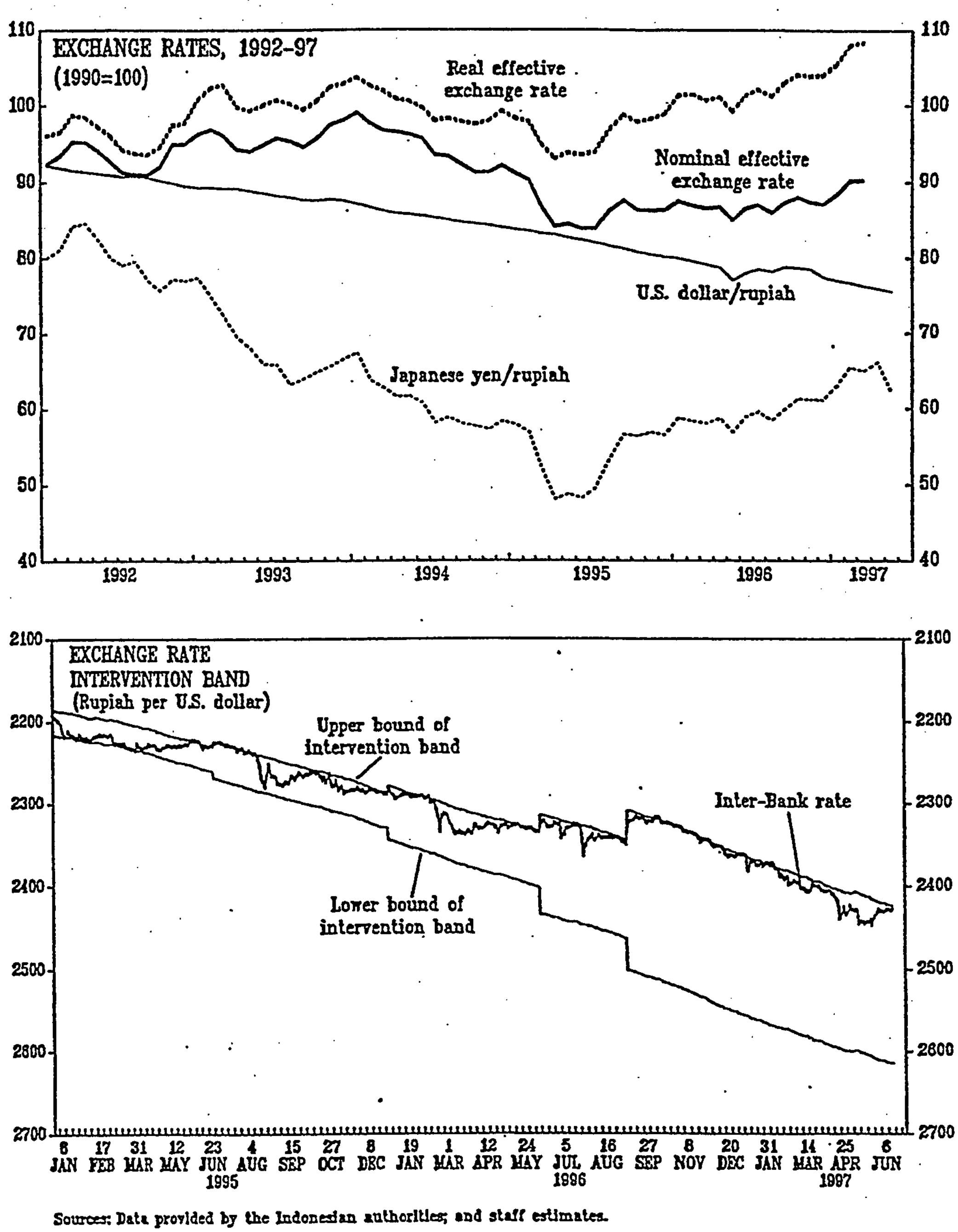


Figure 2.10 Exchange Rate Developments

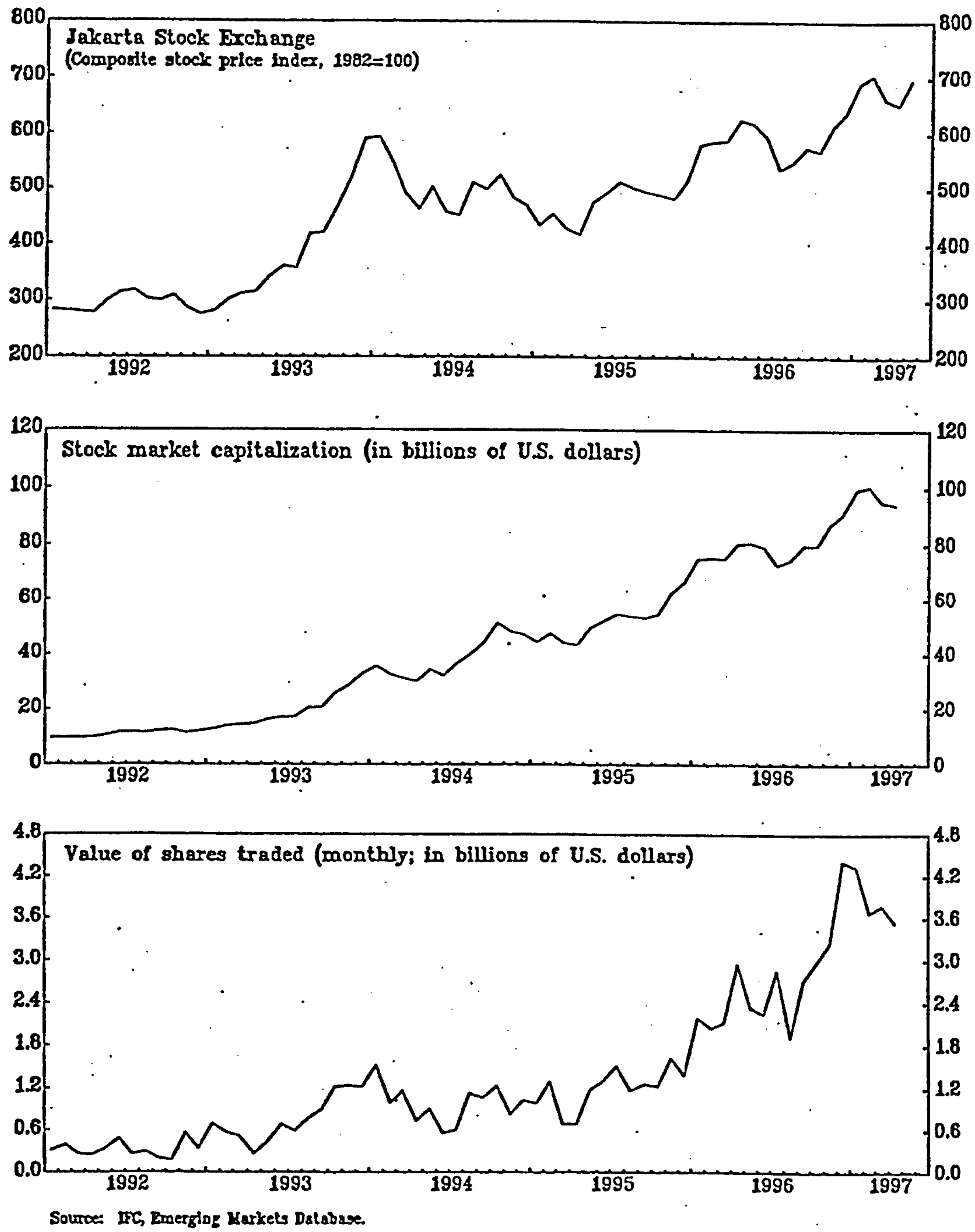


Figure 2.11 Stock Market Developments

4. Balance of Payments[25]

The external current account deficit rose from $6.8 billion (3.3% of GDP) in 1995/96 to $8 billion (3.5% of GDP) in1996/97, mainly due to slower growth of non-oil exports. Total exports grew by 9.4% in 1996/97, substantially below the increase of 13.5% recorded in 1995/96. The surplus on the oil/gas account increased to $4.7 billion, but the non-oil/gas deficit increased to $12.7 billion. Oil/gas exports expanded by 18% because of higher world prices. Non-oil/gas exports grew only by 6.7% in value terms, as the weaker world export demand and competitive pressures from lower-wage regional economies affected Indonesia.

Imports were $50.8 billion in1996/97. Much of the import growth was attributable to capital goods, which make up 25% of total imports, and are closely associated with the expansion of foreign direct investment. Imports grew by 10.3% because of continued buoyant overall economic activity, including high investment. Capital inflows were large throughout the year. The overall balance of payments was estimated to have registered a surplus of $6.1 billion in 1996/97, compared with $3.4 billion in 1995/96. This was reflected in the rise in gross official foreign assets to $27 billion (6 months of imports).[26]

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[25] See Table 2.3 and Figure 2.11.

[26] *IMF Staff Country Report No, 97/75, Indonesia-Recent Economic Development, p.20-21.*

Table 2.3 Indonesia: Summary Balance of Payments

(In millions of U.S. dollars)

	1991/92	1992/93	1993/94	1994/95	1995/96	Est. 1996/97
Current account	-4,114	-2,291	-2,742	-3,329	-6,767	-7,995
Oil/gas sector	4,563	3,515	2,533	3,784	3,473	4,734
Non-oil/gas sector	-8,677	-5,806	-5,275	-7,113	-10,240	-12,729
Export, f.o.b.	29,714	35,303	36,504	42,083	47,754	52,248
Oil	6,869	6,363	5,512	6,311	6,529	7,575
Gas	3,837	4,117	3,822	4,134	4,087	4,954
Non-oil/gas	19,008	24,823	27,170	31,638	37,138	39,619
Import, c.i.f.	27,522	30,312	32,321	37,876	46,071	50,813
Oil	3,206	3,645	3,910	3,724	3,999	4,401
Gas	250	277	288	290	297	298
Non-oil/gas	24,066	26,390	28,123	33,862	41,775	46,114
Oil/gas sector payments (net)	-2,687	-3,043	-2,602	-2,647	-2,847	-3,096
Non-oil/gas services (net)	-3,857	-4,509	-4,522	-5,129	-5,823	-6,434
Official transfers	238	270	200	240	220	200
Capital account	6,086	6,639	4,522	7,206	12,306	11,435
Long-term capital (net)	3,478	3,096	3,407	2,315	4,814	5,308
Official capital	1,947	1,391	1,436	-251	-544	-1,238
Receipts	6,606	6,721	6,939	5,826	5,876	5,906
Amortization 1/	4,659	5,330	5,503	6,077	6,420	7,144
Direct investment	1,531	1,705	1,971	2,566	5,358	6,546
Oil/gas sector export credits	108	142	334	384	371	0
Portfolio investment	0	1,201	1,981	774	1,761	1,748
Other private capital	2,500	2,200	-1,200	3,733	5,361	4,379
Commercial banks' monetary movements	1,062	-1,060	1,967	60	1,279	63
Errors and omissions 2/	-236	1,525	-3,485	-5,384	-3,403	2,556
Overall balance	2,798	4,812	262	-1,447	3,415	6,058
Bank Indonesia (increase -) 3/	-2,798	-4,812	-262	1,447	-3,415	-6,058
Memorandum items:						
Current account						
(In percent of GDP)	-3.1	-1.6	-1.7	-1.8	-3.3	-3.5
Gross official reserves	10.5	12.0	12.7	13.3	16.0	19.9
(In months of imports) 4/	4.8	5.1	4.5	3.8	4.2	4.6
Gross official foreign assets	13.6	18.3	18.6	17.1	20.6	26.6
(In months of imports) 3/, 4/	6.2	7.8	6.6	4.9	5.3	6.2

Sources: Data provided by the Indonesian authorities; and Fund staff estimates.

1/ Includes prepayments.
2/ Includes unrecorded private capital flows.
3/ Includes official assets held as a contingency reserve by Bank Indonesia.
4/ In months of the following year's non-oil/gas imports.

5. External Debt[27]

The stock of external debt was estimated to have risen from $107 billion (53% of GDP) at the end of March 1996 to $113 billion (49% of GDP) at the end of March 1997. Although a substantial part of capital inflows was in the form of non-debt-creating investment, private sector debt increased by $10 billion to $53 billion (23% of GDP). Public sector debt declined by $4 billion to $60 billion (26% of GDP). Repayment amounted to $1.7 billion, primarily to the World Bank and Asian Development Bank. Valuation effects associated with the appreciation of the U.S. dollar against the Japanese yen were estimated to have reduced public debt by $3.6 billion.

External debt service amounted to $13.5 million (33.9% of exports of goods and services) in 1996/97 compared with $12.4 million (33.2% of exports of good and services) in 1995/96. Public debt service (including prepayments) declined to 18% of exports, continuing the trend over the last five years.[28] According to Bank Indonesia, in the 1994/1995 fiscal year, Bank Indonesia statistics note that the service burden on government debt amounted to 17.7% of total export earnings, where as those on private-sector debts only 13.4%. But in the 1995/1996 fiscal year, the debt-service ratio (against export earnings) for the private sector had reached 15.1%, compared to 14.1% for the public sector. Foreign debt has reached US$110 billion US$56

[27] See Table 2.4, 2.5, 2.6 and Figure 2.12.

[28] *IMF Staff Country Report No, 97/75, Indonesia-Recent Economic Development, p.23.*

billion owed by the government and $54 billion by the private sector as of early this year.[29]

[29] *Indonesian Business: The Year in Review 1997, The Castle Group Business Information.*

Table 2.4 Indonesia: External Debt-Service Payments

	1991/92	1992/93	1993/94	1994/95	1995/96	Est. 1996/97
	(In millions of U.S. dollars)					
Total debt-service payments 1/, 2/	8,911	9,238	9,779	11,415	12,431	13,473
Amortization 1/, 2/						
Public sector	4,659	5,330	5,503	6,077	6,420	7,144
Government 2/	4,182	4,840	5,132	5,546	5,939	6,200
(Prepayments)	...	...	...	782	725	1,650
Public enterprises	477	490	371	531	481	944
Interest payments	4,252	3,908	4,276	5,338	6,011	6,329
Public sector	2,912	3,003	3,117	3,421	3,450	3,381
Government	2,647	2,695	2,843	3,060	3,133	3,006
Public enterprises	265	308	274	361	317	375
Private sector 3/	1,340	905	1,159	1,917	2,561	2,948
	(In percent)					
Debt service/exports 4/	33.7	31.4	32.7	33.7	33.2	33.9
Of which: Public sector debt	23.4	21.6	21.4	20.2	18.6	18.0
(excluding prepayments)	...	...	...	18.6	17.2	15.1
Interest payments/exports 5/	13.2	10.1	10.6	11.4	11.3	10.8

Sources: Data provided by the Indonesian authorities

1/ Excludes estimated private sector amortization payments.
2/ Includes prepayments.
3/ Estimated interest based on recorded debt to banks abroad only.
4/ Includes estimated private sector amortization.
5/ As a percentage of exports of goods and nonfactor services.

Table 2.5 Indonesia: External Debt Outstanding

	1991/92	1992/93	1993/94	1994/95	1995/96	Est. 1996/97
			(In billions of U.S. dollars)			
Total external debt (by debtor)	72.2	83.7	89.3	101.2	106.5	113.6
Public sector	48.3	55.5	60.2	67.6	63.5	60.4
Government	44.5	50.9	55.0	62.6	58.6	55.9
Public enterprises	3.8	4.6	5.2	5.0	4.9	4.5
Of which: LNG expansion	3.2	4.0	4.5	4.4	4.3	3.2
Private sector 1/, 2/	24.0	28.2	29.1	33.7	42.9	53.2
Banks	4.1	6.1	8.2	9.0	8.9	9.9
Nonbanks	19.9	22.1	20.9	24.6	34.0	43.3
			(In percent)			
Total external debt (by creditor)						
Public sector	100.0	100.0	100.0	100.0	100.0	100.0
Suppliers' credits	2.5	1.8	1.5	1.5	1.6	1.4
Financial institutions	27.2	25.4	25.8	26.1	26.0	26.6
Bonds	1.4	0.7	0.2	0.1	0.0	0.7
Multilateral institutions	28.1	30.0	29.3	28.2	30.3	29.7
Bilateral	34.0	34.7	35.7	37.5	35.1	36.1
Nationalization	0.2	0.2	0.1	0.1	0.1	0.1
LNG expansion	6.6	7.3	7.4	6.5	6.8	5.4
Memorandum items:			(In percent)			
Outstanding debt/GDP	56.4	58.9	55.8	56.2	52.9	49.7
Public sector debt/GDP	37.7	39.1	37.6	37.5	31.6	26.4
Private debt/GDP	18.7	19.8	18.2	18.7	21.3	23.3
Outstanding debt/exports of goods and nonfactor services	223.5	216.7	221.6	215.7	200.3	193.8
Public debt on concessional terms 3/	45.6	47.3	47.1	43.9	39.7	35.4
Share of public debt denominated in:						
U.S. dollars	42.2	41.4	38.3	36.7	42.0	43.5
Japanese yen	40.0	41.2	45.3	45.3	39.8	38.1

Sources: Data provided by the Indonesian authorities, World Bank Debtor Reporting System, and BIS, International Banking and Financial Market Developments; and staff estimates.

1/ Until 1993/94, based on BIS data. From 1994/95, new staff estimates for private nonbank debt are based on improved coverage of private debt by Bank Indonesia.
2/ Based on recorded debt to banks abroad only.
3/ Public debt at variable rates or on concessional terms in percent of total public debt; calendar year.

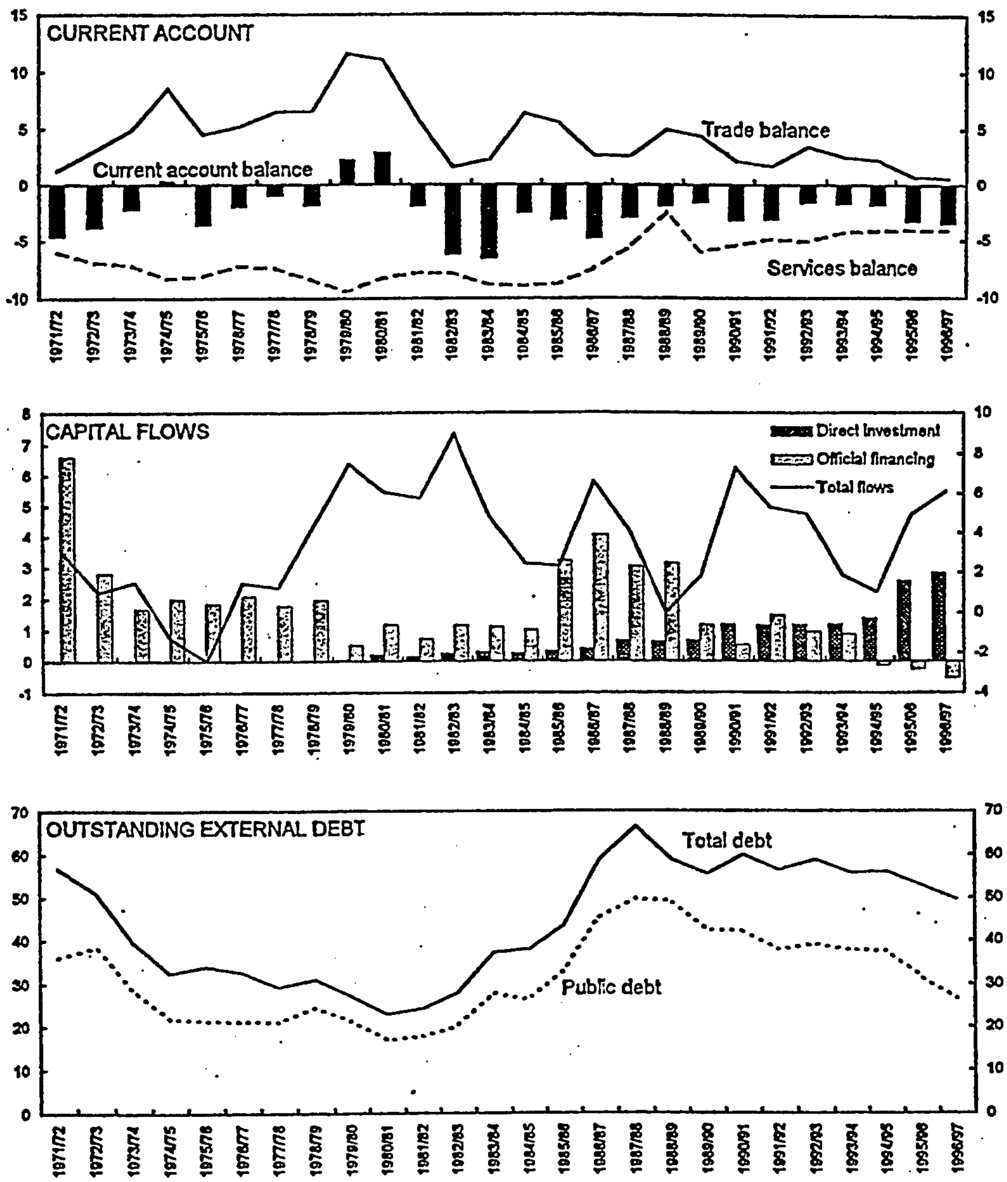
Table 2.6. Indonesia: Public Sector External Debt Transactions

(In millions of U.S. dollars)

	1991/92	1992/93	1993/94	1994/95	1995/96	Est. 1996/97
Government sector						
Outstanding debt at beginning of period	44,876	44,484	50,887	55,037	62,569	58,610
Net drawings	1,418	915	1,063	105	-209	-794
Drawings 2/	5,600	5,755	6,195	5,651	5,730	5,406
Amortization 3/	4,182	4,840	5,132	5,546	5,939	6,200
Adjustment 4/	-1,810	5,488	3,087	7,427	-3,750	-1,949
Outstanding debt at end of period	44,484	50,887	55,037	62,569	58,610	55,867
Public enterprises						
Outstanding debt at beginning of period	3,135	3,771	4,610	5,182	5,009	4,903
Net drawings	529	746	573	-116	-115	-244
Drawings 2/	1,006	1,236	944	415	366	700
Amortization	477	490	371	531	481	944
Adjustment 4/	107	94	-1	-57	9	-156
Outstanding debt at end of period	3,771	4,610	5,182	5,009	4,903	4,503
Public sector--total						
Outstanding debt at beginning of period	48,011	48,255	55,497	60,219	67,578	63,513
Net drawings	1,947	1,661	1,636	-11	-324	-1,038
Drawings 2/	6,606	6,991	7,139	6,066	6,096	6,106
Amortization 3/	4,659	5,330	5,503	6,077	6,420	7,144
Adjustment 4/	-1,703	5,582	3,086	7,370	-3,741	-2,105
Outstanding debt at end of period	48,255	55,497	60,219	67,578	63,513	60,370
Public sector debt service 3/	7,571	8,333	8,620	9,498	9,870	10,525
Amortization 3/	4,659	5,330	5,503	6,077	6,420	7,144
Interest	2,912	3,003	3,117	3,421	3,450	3,381

Source: Data provided by the Indonesian authorities.

1/ Excludes loans of maturity up to of one year and transactions with to the IMF.
2/ As recorded in debt records of Bank Indonesia. Excludes drawings made in connection with prepayments.
3/ Includes prepayments.
4/ Mainly reflects valuation adjustments owing to changes in exchange rates, and an adjustment for the estimated grant component of public sector drawings.



Sources: Data provided by the Indonesian authorities; and staff estimates.

Figure 2.12 External Sector Indicators

III. INDONESIAN CRISIS IN 1997-1998

A. INDICATION OF THE CRISIS

To predict the crisis in Indonesia before it happened is quite difficult. In December 1997 the IMF said, "Just two or three months ago, neither economic forecasts nor the pricing of assets in financial markets foretold the depth and breadth of the economic and financial difficulties that have engulfed several southeast (Indonesia) and east Asian economies and that affects emerging market economies more generally. It may well be that such developments are inherently **nonforecastable**, as their occurrence and especially their timing are intimately linked to sudden changes in investor sentiment and financial market conditions.[30]"

Indonesia recently broke into the ranks of the world's most competitive countries, moving to the top 20-most competitive economies. Indonesia was 15th, after ranking 30th in 1996, according to Global Competitive Report 1997 issued by the Geneva-based World Economic Forum. Even when Indonesia felt the pressure of the crisis in October 1997, the World Bank's country director for Indonesia, Denis de Tray, said in Jakarta that "Indonesia's" macroeconomic foundation remains sound despite recent pressures in the foreign exchange markets. This strong foundation has allowed Indonesia to generate remarkably consistent high growth over the past 30 years, with an increasingly open

[30] *IMF, World Economic Outlook,Interim Assessment, December 1997.*

economy and impressive progress in poverty reduction."[31] But some articles or comments before the crisis could be considered as an early indication of the financial crisis in Indonesia. (See Table 3.1, 3.2)

An article in Asiamoney magazine July/August 1996 mentioned that

> between July and August 1995, Indonesia's simmering economy threatened **to overheat**. All the alarm bells were ringing. Wages were on the rise, rising food prices pushed inflation dangerously close to double digits and growth in bank loans peaked, adding liquidity to an already-saturated monetary system. Then there was the ballooning current account deficit, with economists predicting non-oil imports would grow by over 30%, compared with an 18% increase in exports. But by December 1995, the economy was taken off the boil. The country's finance minister, Mar'ie Muhammad, was able to announce a budget surplus of 1% of GDP and non-oil import growth leveled out at a less dramatic 27% for the year. Inflation also cooled, falling back to 8.64%. The government's recovery was well orchestrated. Some last minute measures by the government (Indonesia's finance ministry) saved the economy from overheating, but, **the challenge now is to keep a handle on the current account deficit and inflation**, while averaging an annual growth in GDP of 7%.[32]

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[31] *The World Bank, World Bank Strengthens Support For Indonesia, News Release No. 98/1503, October 9, 1997.*

[32] *Cherrie Marriott, Battling the bulge, Asia money, July/August 1996.*

Table 3.1 Selected Crisis Indicators

Country	Current Account/GDP (%) 1996	Capital Account/GDP (%) 1996	Real Exchange Rate (1990=100) 1996	Financial Inst. Claims on Private Sector/GDP (%) 1990	1996	Short Term Debt/Reserves June 1994	June 1997
Argentina	-1.4	2.5	44	15.6	18.4	1.3	1.2
Brazil	-2.7	4.4*	20	40.8	30.7	0.7	0.8
Chile	-4.1	8.8	61	47.0	57.0	0.5	0.4
Colombia	-5.5	7.9	...	30.8	41.2	0.5	0.7
India	-1.6	3.1*	...	26.8	24.7	0.3	0.3
Indonesia	-3.5	4.9	80	50.6	55.4	1.7	1.7
Jordan	-3.1	5.4	...	64.4	65.3	0.5	0.4
Korea	-4.8	4.8	88	56.8	65.7	1.6	2.1
Malaysia	-5.3	9.4	78	71.4	144.6	0.3	0.6
Mexico	-0.6	1.2	95	22.7	21.6	1.7	1.2
Pakistan	-5.6	4.1*	...	27.7	26.7	0.7	2.4
Peru	-5.9	5.1	...	10.1	19.6	0.4	0.5
Philippines	-4.3	11.0	56	19.3	48.4	0.4	0.8
South Africa	-1.6	2.1	...	85.0	137.7	15.0	3.1
Sri Lanka	-4.7	4.2	...	19.6	25.2	0.3	0.2
Taiwan	4.4	-4.0	...	97.0	165.0	0.2	0.2
Thailand	-8.0	10.6	80	83.1	141.9	1.0	1.5
Turkey	-0.8	5.0	...	16.7	23.5	2.1	0.8
Venezuela	13.1	-2.6	...	25.4	9.6	0.8	0.3
Zimbabwe	...	...	...	23.0	31.2	1.3	1.6

* 1995 data

Sources: Bank for International Settlements, IMF, author's calculations

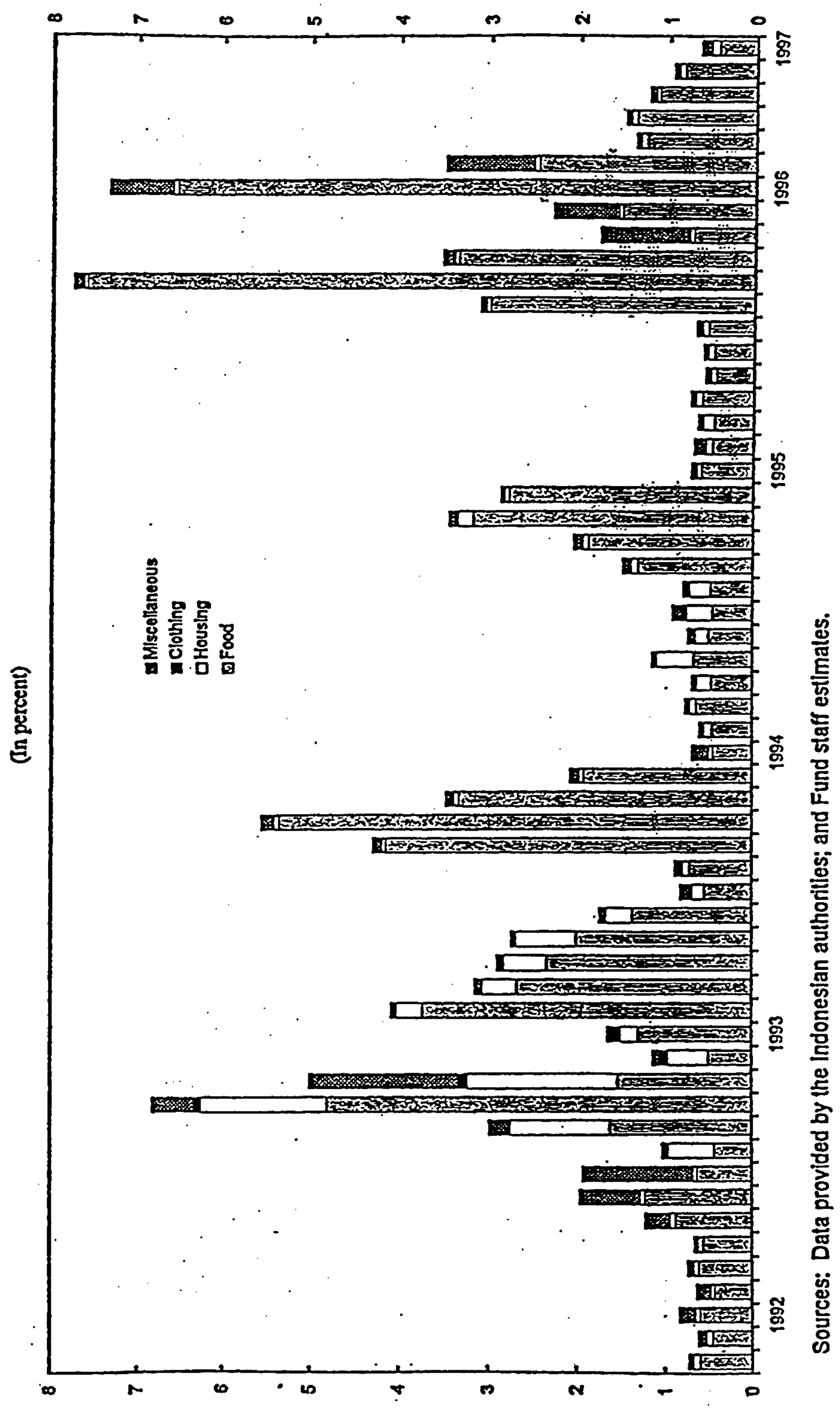

Figure 3.1 Indonesia: Variability of Inflation

The article also explained that many corporations were going offshore for their financing. Many more were also turning to the rapidly developing equity market for funds. By raising money offshore and bringing in high-tech machinery from overseas, Indonesia's manufacturers were adding to the current account deficit. Even though the government managed to keep import growth below 30% in 1995, the deficit still topped US$7.2 billion or 3.6% of GDP, more than double the level in 1994. **The economists say it is worryingly high**. The problem is a severe imbalance between the number of exports leaving the country and the large influx of imports.

For most of 1995, growth in imports outpaced growth in exports by 10%-15%. **In the short-term, Indonesia will remain victim to the classic emerging market conundrum of high investment levels versus a sound balance of payments.**[33] High-tech machinery being brought in to equip new factories will invariably impact on the current account deficit. "With foreign direct investment increasing you are getting more imports of raw materials and capital goods and once these machines start churning out exports, the pain will be repaid, but a larger percentage of direct investment these days is directed towards manufacturing for domestic market," says Jonathan Haris, an analyst with HG Asia.[34]

In 1986, the government devalued the rupiah (Indonesian money) by 31% against the U.S. dollar and moved from a floating exchange rate to one managed within a band against a weighted basket of currencies. Since then, Bank Indonesia has intervened by buying and selling U.S. dollars with the aim of depreciating the rupiah against the dollar by about

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[33] *Cherrie Marriott, p 5-6.*

[34] *Cherrie Marriott, p.6.*

5% a year. The intervention is basically designed to ensure as little long-term movement as possible, but most importantly, it maintains the competitiveness of Indonesia's exports. In early 1996, Bank Indonesia widened its intervention band for the exchange rates from about 3% to 5%, primarily due to the widening interest rate differential-foreign interest rates have declined, while Indonesia's remain high. CS First Boston's report on the rupiah explains, a conflict has arisen between the governments monetary and exchange rate policies. To avoid an overheating economy, the government keeps interest rates high, but as a result, foreign inflows have increased. Indonesia has become a favorite with foreign portfolio investors and great deal **of short-term money is now flowing into the country, adding fuel to the inflation fire**. Yet, the government refuses to allow the rupiah to appreciate.[35]

Indonesia's foreign debt also has long been a concern for economists. Sovereign debt rose steadily year by year, increasing from US$79.78 in 1991 to US$109.00 in 1996 and estimated to US $ 137.42 in 1997. (See Table 3.2, 3.3, 3.4). Indonesia has borrowed heavily in Yen even though most of its exports are dollar denominated. (See Table 3.5) In the first quarter of 1995, **the country fell victim to the sharp swings in the US dollar/yen exchange rate**. According to the World Bank, the depreciation of the U.S. dollar added about US$6 billion to Indonesia's external public debt and could have increased to approximately US$750 million.

> Indonesia recognizes that it has too much of this debt because much of their oil sales are dollar denominated and so are a vast majority of their

[35] *Cherrie Marriott, p.7.*

exports, says Denise de Tray in 1996, resident representative for the World Bank in Jakarta.[36]

An article in the Kompas newspaper in April 16, 1996 explained that

> Indonesian export was no more the rising star but had already become the falling star. Since 1993, the growth of Indonesian export was decreasing and tends to slowdown. Even more, it became the lowest among the countries in the region (Thailand, Malaysia, the Philippines, China and India). This condition occurred because the export commodities did not have the technical advantages, they lacked labor skills and there were weaknesses in industrial structures. If the conditions did not change, therefore, Indonesia's economy would be troubled in the future.[37]

At the conference on Business Process Re-engineering in Banking and Finance, organized by the Asia Business Forum, J.S. Djiwandono, governor of Bank Indonesia said

> Due in part to tighter competition, **banks have also become involved in certain high risk activities**. Over the past few years, we noticed some banks engaged more aggressively in lending to the property sector. In 1996, bank lending to that sector grew nearly 40%. Due to this high growth, the share of bank loans in the property sector to the total outstanding loans rose to around 20% in 1996 compared with 13% in 1993. In recent years, off balance sheet banking activities have also showed a significant increase. This is indicated by a particularly rapid growth in off balance sheet liabilities, consisting of open forward selling positions and credit commitments. **These activities, particularly those linked to derivative transactions, also involve high risk**

[36] *Cherrie Marriott, p 7.*

[37] *Kompas, Sangatlah Benar, Laju Pertumbuhan Expor Sudah Mengkhawatirkan, April 16, 1996.*

for banks. Meanwhile, the employment of such sophisticated technology **does pose considerable risk** as well, both born insufficient planning and imperfect development, and risk incurred at the time of operation.[38]

[38] *J.S. Djiwandono, The Banking Industry Facing the 21st Century, Bank Indonesia.*

Table 3.2 Indonesia: External Debt
Source: Bank Indonesia

INDONESIA: EXTERNAL DEBT	
(As of December 31, 1997, updated on February 23, 1998)	
	(in millions)
Total External Debt	**USD 136.088**
I. Public Sector	**USD 67.773**
A. Government	**USD 54.110**
Of Which IMF Credit USD 3,0 billions	
B. State Owned Enterprises	**USD 13.663**
1. State Banks	USD 7.280
i. Bank Credit	USD 5.910
ii. CP/MTN/FRN	USD 1.370
2. Non-Bank Enterprises	USD 6.383
i. Bank Credit	USD 3.995
ii. CP/MTN/FRN	USD 2.388
II. Private Sector	**USD 68.315**
1. Private Banks	USD 9.409
i. Bank Credit	USD 8.454
a. Foreign Banks	USD 529
b. Joint Venture Banks	USD 3.801
c. Domestically Owned Banks	USD 4.124
ii. CP/MTN/FRN	USD 955
2. Non-Bank Corporations	USD 58.906
i. Bank Credit	USD 53.593
a. Foreign Investment (PMA)	USD 23.473
b. PMDN dan Non PMDN	USD 30.120
ii. CP/MTN/FRN	USD 5.313
Notes:	
CP : Commercial Papers	
MTN : Medium Term Notes	
FRN : Floating Rate Notes	

Table 3.3. Short term Debt and Reserves, 1994 and 1997

(Millions of US$)

Country	June 1994 Short-Term Debt	June 1994 Reserves	June 1994 Short-Term Debt/Reserves	June 1997 Short-Term Debt	June 1997 Reserves	June 1997 Short-Term Debt/Reserves
Argentina	17,557	13,247	1.325	23,891	19,740	1.210
Brazil	28,976	41,292	0.702	44,223	55,849	0.792
Chile	5,447	10,766	0.506	7,615	17,017	0.447
Colombia	3,976	7,718	0.515	6,698	9,940	0.674
India	5,062	16,725	0.303	7,745	25,702	0.301
Indonesia	18,822	10,915	1.724	34,661	20,336	1.704
Jordan	647	1,291	0.501	582	1,624	0.358
Korea	35204	21,685	1.623	70,182	34,070	2.060
Malaysia	8,203	32,608	0.252	16,268	26,588	0.612
Mexico	28,404	16,509	1.721	28,226	23,775	1.187
Pakistan	1,708	2,307	0.740	3,047	1,249	2.440
Peru	2,157	5,611	0.384	5,368	10,665	0.503
Philippines	2,646	6,527	0.405	8,293	9,781	0.848
South Africa	7,108	475	14.964	13,247	4,241	3.124
Sri Lanka	511	1,983	0.258	414	1,770	0.234
Taiwan	17,023	90,143	0.189	21,966	90,025	0.244
Thailand	27,151	27,375	0.992	45,567	31,361	1.453
Turkey	8,821	4,279	2.061	13,067	16,055	0.814
Venezuela	4,382	5,422	0.808	3,629	13,215	0.275
Zimbabwe	704	534	1.319	731	447	1.635

Sources: Bank for International Settlements, IMF

Table 3.4. International Claims Held By Foreign Banks

- Distribution by maturity and sector

(Billion of dollars)

	Total Outstanding	Obligations by Sector: Banks	Public Sector	Non-bank Private	Short Term	Reserves	Short Term/Reserves
A. End 1995							
Indonesia	44.5	8.9	6.7	28.8	27.6	14.7	1.9
Malaysia	16.8	4.4	2.1	10.1	7.9	23.9	0.3
Philippines	8.3	2.2	2.7	3.4	4.1	7.8	0.5
Thailand	62.8	25.8	2.3	34.7	43.6	37	1.2
Korea	77.5	50.0	6.2	21.4	54.3	32.7	1.7
Total	209.9	91.3	20.0	98.4	137.5		
B. End 1996							
Indonesia	55.5	11.7	6.9	36.8	34.2	19.3	1.8
Malaysia	22.2	6.5	2.0	13.7	11.2	27.1	0.4
Philippines	13.3	5.2	2.7	5.3	7.7	11.7	0.7
Thailand	70.2	25.9	2.3	41.9	45.7	38.7	1.2
Korea	100.0	65.9	5.7	28.3	67.5	34.1	2.0
Total	261.2	115.2	19.6	126.0	166.3		
C. Mid-1997							
Indonesia	58.7	12.4	6.5	39.7	34.7	20.3	1.7
Malaysia	28.8	10.5	1.9	16.5	16.3	26.6	0.6
Philippines	14.1	5.5	1.9	6.8	8.3	9.8	0.8
Thailand	69.4	26.1	2.0	41.3	45.6	31.4	1.5
Korea	103.4	67.3	4.4	31.7	70.2	34.1	2.1
Total	274.4	121.8	16.7	136.0	175.1		
Memo Item: Mexico							
end-1994	64.6	16.7	24.9	22.8	33.2	6.4	5.2
end-1995	57.3	11.5	23.5	22.3	26.0	17.1	1.5

Source: Bank For International Settlements

Table 3.5. International Claims Held By Foreign Banks

- Distribution by country of origin

(Billion of dollars)

	Total Outstanding	Claims held by banks from: Japan	U.S.A.	Germany	All others
A. End 1995					
Indonesia	44.5	21.0	2.8	3.9	16.8
Malaysia	16.8	7.3	1.5	2.2	5.8
Philippines	8.3	1.0	2.9	0.7	3.7
Thailand	62.8	36.9	4.1	5.0	16.8
Korea	77.5	21.5	7.6	7.3	41.1
Sub-total	209.9	87.7	18.9	19.1	84.2
Total, all reporting countries *		429.3	132.6	264.0	
B. End 1996					
Indonesia	55.5	22.0	5.3	5.5	22.7
Malaysia	22.2	8.2	2.3	3.9	7.8
Philippines	13.3	1.6	3.9	1.8	6.0
Thailand	70.2	37.5	5.0	6.9	20.8
Korea	100.0	24.3	9.4	10.0	56.3
Sub-total	261.2	93.6	25.9	28.1	113.6
Total, all reporting countries *		389.4	165.7	292.3	
C. Mid-1997					
Indonesia	58.7	23.2	4.6	5.6	25.3
Malaysia	28.8	10.5	2.4	5.7	10.2
Philippines	14.1	2.1	2.8	2.0	7.2
Thailand	69.4	37.7	4.0	7.6	20.1
Korea	103.4	23.7	10.0	10.8	58.9
Sub-total	274.4	97.2	23.8	31.7	121.7
Total, all reporting countries *		404.4	166.3	301.2	

* Reporting countries include G-10 plus Austria, Denmark, Finland, Ireland, Luxembourg, Norway, Spain, plus 15 financial centers

Source: Bank For International Settlements

Table 3.6. Balance of Payments 1985-96 (% of GDP)

	Korea		Indonesia		Malaysia		Philippines		Thailand	
	1985-89	1990-96	1985-89	1990-95	1985-89	1990-95	1985-89	1990-96	1985-89	1990-95
Current Account	4.3	-1.7	-2.5	-2.5	2.4	-5.6	-0.5	-3.3	-2.0	-6.8
Balance of Trade	3.6	-1.2	5.9	4.5	13.7	3.2	-2.9	-8.7	-2.2	-4.7
Exports	30.7	25.0	21.9	24.2	56.1	73.2	17.1	17.4	22.9	29.6
Imports	-27.2	-26.2	-15.9	-19.7	-42.5	-70.0	-20.0	-26.1	-25.1	-34.3
Capital and Financial Account	-2.5	2.5	3.5	4.1	0.5	9.6	1.4	5.5	4.2	10.2
Direct Investment (net)	-0.1	-0.3	0.5	1.2	2.4	6.9	1.0	1.1	1.1	1.5
Portfolio Investment (net)	0.2	1.9	-0.0	0.9	1.0	-1.0	0.2	0.3	1.2	1.5
Equity Securities	0.0	0.8	0.0	0.5	0.0	0.0	0.0	0.0	0.8	0.7
Debt Securities	0.1	1.1	-0.0	0.4	1.0	-1.0	0.2	0.3	0.4	0.9
Other Investment (net)	-2.4	1.0	3.0	2.0	-2.8	3.8	0.2	4.0	2.0	7.1
Monetary Authorities	-0.0	-0.0	0.0	0.0	0.0	0.0	-0.6	0.0	0.0	0.0
General Government	-1.2	-0.3	2.6	0.5	-1.7	-0.3	2.3	1.1	0.2	-0.4
Banks	-0.8	0.1	0.0	0.4	-1.0	1.8	-0.2	1.4	0.2	3.5
Other Sectors	-0.4	1.2	0.4	1.2	-0.0	2.4	-1.2	1.6	1.5	4.0
Financing	-1.7	-0.6	-0.1	-1.1	-2.9	-5.0	-1.8	-1.8	-3.0	-3.6
Reserve Assets	-1.4	-0.6	-0.2	-1.0	-2.7	-5.0	-1.0	-1.7	-2.7	-3.5

B. THE UNFOLDING OF THE CRISIS: EPISODES

In 1995, Indonesia's real GDP growth reached 8.1%-up from rates of 7.3% in 1993 and 7.5% in 1994, respectively. This growth brought along worrying signs of overheating, such as an inflation rate of 9.4%, a sharp 41% drop in the country's trade surplus (from US$8.1 billion in 1994 to US$4.8 billion in 1995), due to a surge in consumer imports, and a corresponding increase in the current account deficit from US $2.8 billion (1.7% of GDP) in 1994 to US$7.9 billion (3.9% of GDP) in 1995. (See Table 3.6 for more information) The government's response was a deflationary budget and a tightening of monetary policy. Throughout 1995, Bank Indonesia raised interest rates, and in January 1996, raised reserve requirements for commercial banks from 2% to 3%. In September 1996, the bank announced that it would increase the requirements further to 5% in April 1997. The bank also increased its efforts at moral suasion in an attempt to moderate the expansion of bank credit. Bank Indonesia also faced an awkward balancing act, hoping to dampen domestic demand, but not wanting higher interest rates to fuel speculative inflows.

In an effort to meet both objectives, Bank Indonesia widened the rupiah's trading band from 2% to 3% around the daily midrate hoping that the added trading risk of holding the rupiah would offset more attractive interest rates. Again the band widened from 3% to 5% in June 1996 and from 5% to 8% in September 1996. But the broader bands did little to discourage capital inflows, as the promise of higher interest rates pushed the rupiah upward on each of these occasions.

In 1996, signs of overheating did abate, with real GDP growth slowing to 7.8%, and inflation dropping to 6.6%. The current account deficit remained at around 3.3% of GDP and was largely financed by short-term inflows of portfolio capital. With signs of easing growth, Bank Indonesia cut rates by 0.5% in December 1996 and by 0.5 in March 1997, hoping to moderate the inflow of capital, ease the debt burden on struggling Indonesian firms, and allow increases in exports. In the meantime, many Indonesian banks and companies were still borrowing very heavily in international capital markets. (See Table 3.3, 3.4, 3.5, 3.6).

In its annual report on Indonesia, the World Bank has estimated that Indonesia's 1996-1997 current account deficit will reach US$8.1 billion, or 3.5% of the country's Gross Domestic Product (GDP). The World Bank also said that in 1997-1998 the deficit would reach US$10.1 billion or 4% of the GDP. However, the Bank praised the country's economic performance and credited the government's fiscal and monetary policies for helping to solve the structural problems in the economy, particularly high inflation. The Bank repeated its call to the government to abolish the subsidies on fuel and power, increase forestry levies, maintain the momentum of deregulation, improve the high-risk banking sector and its exposure toward the property sector and improve governance to push down business costs and maintain competitiveness.

1. July 1997

On July 2, 1997, The Bank of Thailand announced a managed float of the baht and called on the International Monetary Fund for technical assistance. The announcement effectively devalued the baht by about 15-20%, and its trigger for the East Asian crises. The Philippines' central bank was forced to intervene heavily to defend the peso. On July 3, the Philippines central bank raised the overnight lending rate to 24% from 15%. On July 8, Malaysia's central bank, Bank Negara, had to intervene aggressively to defend the ringgit. The intervention worked and the currency hit a high of 2.5100/10 after a low of 2.5240/50[39].

In Indonesia, the rupiah started to crumble, and on July 11, the authorities widened its rupiah-trading band to 12% from 8%, however, this step was unable to stop the tendency of the weakening rupiah. On July 21, pressures against the rupiah increased, and Bank Indonesia was forced to make several interventions by spending the reserved funds of around US$1.5 billion.

On July 11, the Philippines central bank said in a statement it would allow the peso to move in a wider range against the dollar, and if the IMF backed the move, it would approve the Philippines' request for an extension of its Extended Fund Facility (EFF). On July 14, the IMF offered the Philippines almost $1.1 billion in financial support. On July 14, the Malaysian central bank abandoned the defense of the ringgit, and on July 24, Malaysian Prime Minister, Mahathir Mohamad, launched a bitter attack on "rouge speculators" after the ringgit hit a 38-month low of 2.6530 to the dollar. Around this time, the Singapore dollar started a gradual decline and the Singapore authority allowed the depreciation of the Singapore dollar.

By the end of July 1997, several Asian currencies-the Thai baht, the Malaysian ringgit, the Philippine peso and the Indonesian rupiah- all slumped, as confidence in the region rapidly deteriorated, reflective a perceived currency meltdown. The baht had fallen by 25%(relative to the beginning of 1997) while the ringgit fell by 4%, peso by 10% and the rupiah by 9%. After the deflation rate of 0.17% in June, Indonesia had an inflation rate of 3.20% in July. It was caused by the increase in the food indices by 1.10%, housing by 0.21%, clothing by 0.19%, and miscellaneous indices by 0.70%. The inflation rate from January to July

[39] See Table 3.7, 3.8.

3.20%. Foreign direct investment approvals declined for the year to July to reach US$16.2 billion; for the same period last year, it reached US$21.5 billion. Domestic investment on the other hand increased in the value to Rp70.8 trillion in 1996.

In the early part of the month, the government had issued the latest deregulation package, which effectively cut import tariffs on 1,600 items, slashed the number of local taxes and fees and allowed imports of used cargo and fishing vessels. After this latest package, 62.55% of Indonesia's total tariff codes would be in the range of 0 to 10%. This reform also decreased the Indonesian average unweighted import tariff from 13% to 11.9%, the second lowest in Southeast Asia after Singapore. Indonesian donors pledged US$5.3 billion in fresh aid at the conclusion of a two day meeting of the Consultative Group on Indonesia. The amount was slightly higher than the US$5.26 billion secured by Indonesia from the same group last year.

Table 3.7. Money and Credit

	1990	1991	1992	1993	1994	1995	1996
Indonesia							
M2 (share of GDP)	43.3	43.7	45.8	43.4	44.9	48.3	52.5
M2 (annual growth rate)		17.5	19.8	20.2	20.0	27.2	27.2
Claims on Private Sector (share of GDP)	50.6	50.7	49.5	48.9	51.9	53.7	55.8
Claims on Private Sector (annual growth rate)		16.7	11.4	25.5	23.0	22.6	21.4
Malaysia							
M2 (share of GDP)	66.2	69.3	78.9	90.6	88.9	92.7	97.8
M2 (annual growth rate)		16.9	29.2	26.6	12.7	20.0	21.8
Claims on Private Sector (share of GDP)			111.4	113.3	115.0	129.6	144.6
Claims on Private Sector (annual growth rate)				12.1	16.5	29.7	28.9
Philippines							
M2 (share of GDP)	34.1	34.5	36.2	42.1	45.7	50.4	54.0
M2 (annual growth rate)		17.3	13.6	27.1	24.4	24.2	23.2
Claims on Private Sector (share of GDP)	19.3	17.8	20.6	26.4	29.1	37.5	48.6
Claims on Private Sector (annual growth rate)		7.3	25.4	39.6	26.5	45.2	48.7
Thailand							
M2 (share of GDP)	69.8	72.7	74.8	78.9	78.5	80.8	79.9
M2 (annual growth rate)		19.8	15.6	18.4	12.9	17.0	12.6
Claims on Private Sector (share of GDP)	83.1	88.6	98.4	110.8	128.1	142.0	141.9
Claims on Private Sector (annual growth rate)		22.7	24.8	26.3	31.2	26.0	13.7
Korea							
M2 (share of GDP)	38.3	38.8	40.0	42.0	43.5	43.7	45.7
M2 (annual growth rate)		21.9	14.9	16.6	18.7	15.6	15.8
Claims on Private Sector (share of GDP)	102.5	103.1	110.7	121.3	128.8	133.5	140.9
Claims on Private Sector (annual growth rate)		20.9	19.6	21.8	21.6	19.2	17.0

Table 3.8. Net foreign Assets of the Banking System

(share of GDP)

	1990	1991	1992	1993	1994	1995	1996
Indonesia							
Foreign Assets of the Banking System (net)	5.4	7.6	11.4	8.6	6.4	6.7	9.6
Monetary Authorities (net)	5.9	8.0	12.6	11.4	9.5	8.9	11.3
Deposit Money Banks (net)	-0.5	-0.4	-1.2	-2.8	-3.1	-2.2	-1.7
Foreign Assets	6.0	4.9	5.0	3.4	3.4	3.8	3.9
Foreign Liabilities	6.5	5.2	6.2	6.2	6.5	6.0	5.6
Malaysia							
Foreign Assets of the Banking System (net)	22.1	18.7	23.0	34.3	33.2	27.2	23.7
Monetary Authorities (net)	23.3	23.5	32.2	47.3	36.7	29.8	28.2
Deposit Money Banks (net)	-1.3	-4.8	-9.2	-13.0	-3.5	-2.6	-4.9
Foreign Assets	5.8	4.3	3.6	6.5	5.7	4.8	4.4
Foreign Liabilities	7.0	9.1	12.7	19.5	9.2	7.4	9.2
Philippines							
Foreign Assets of the Banking System (net)	-9.1	-1.5	2.6	7.4	7.4	6.2	3.2
Monetary Authorities (net)	-13.0	-5.5	-0.6	3.8	5.4	6.2	10.6
Deposit Money Banks (net)	4.0	4.0	3.1	3.5	2.0	-0.0	-7.4
Foreign Assets	10.2	8.4	8.7	9.0	8.7	8.8	9.8
Foreign Liabilities	6.2	4.4	5.6	5.5	6.7	8.8	17.2
Thailand							
Foreign Assets of the Banking System (net)	14.0	16.4	15.9	14.3	4.1	0.0	-1.7
Monetary Authorities (net)	16.5	18.5	19.0	20.4	21.0	22.7	21.2
Deposit Money Banks (net)	-2.4	-2.0	-3.2	-6.1	-16.9	-22.6	-22.9
Foreign Assets	2.6	2.9	2.7	5.0	4.7	5.8	3.9
Foreign Liabilities	5.0	4.9	5.9	11.1	21.6	28.4	26.8
Korea							
Foreign Assets of the Banking System (net)	5.7	3.8	5.1	6.6	6.7	6.4	5.2
Monetary Authorities (net)	6.0	4.9	5.7	6.2	6.8	7.2	7.2
Deposit Money Banks (net)	-0.3	-1.1	-0.6	0.4	-0.1	-0.8	-2.0
Foreign Assets	3.8	3.8	4.2	4.9	5.4	6.1	7.3
Foreign Liabilities	4.1	4.9	4.8	4.5	5.5	6.9	9.3

2. August 1997

In the first week of August, jittery Indonesian companies, fearful that the rupiah would continue to lose value against the U.S. dollar, sold the local currency in increasing quantities. In turn, international banks writing options for clients were forced to hedge their own positions. On August 4, Bank Indonesia increased the interest rates of SBI (Bank of Indonesia Certificates) for a six-day period from 6% to 15% and for a period of more than a week from 7% to 10%. At this time, Bank Indonesia also froze the commercial papers (SBPU). On August 11th, in the face of massive selling pressure, the governor of the central bank (Bank Indonesia) called in the domestic banks and asked them to support the rupiah.

On August 13th, the rupiah began to come under severe pressure. It hit a historic low of Rp2,682 to the dollar before ending at Rp2,655. The central bank actively intervened in its defense. Bank Indonesia spent $500 million in an effort to hold the currency within its 12% trading band. Neither action had any effect. After several days of decline of the rupiah and realizing that the intervention band itself attracted speculative attacks, on August 14, 1997, Indonesia abolished its system of managed exchange rate and the rupiah was allowed to float. Stanley Fischer, acting Managing Director of the IMF said,

> The management of the IMF welcomes the timely decisions of the Indonesian authorities. The floating of the rupiah, in combination with Indonesia's strong fundamentals, supported by prudent fiscal and monetary policies, will allow its economy to continue its impressive economic performance of the last several years.[40]

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[40] *IMF Welcomes Indonesia's Exchange Rate Action, IMF News Brief No. 97/18, August 14, 1997.*

The landmark decision, which followed renewed attacks on Southeast Asian currencies, came after a closed door meeting between Bank Indonesia Governor Soedradjad Djiwandono, Finance Minister Mar'ie Muhammad, Information Minister R. Hartono and senior editors of the local media. Eventually, the monetary authority released the intervention band and submitted the rupiah exchange value to the market mechanism. This step was taken to protect the reserved funds. And in stabilizing the rupiah's value, wherever necessary, the government would make indirect intervention through fiscal and monetary policy. A day later, an increase in rupiah selling caused the rupiah value against the dollar to drop to Rp3.000 per U.S. dollar.

On August 19th, The monetary authority increased the SBI from 10.5% to 20% (for one week), 22$ (for two weeks), and 30% (for one month). This measure was taken to curb foreign currency speculations. On August 20th, Deposit funds from government-owned companies and pension funds in the banks were withdrawn from Bank Indonesia accounts. It was estimated that Rp12 trillion was withdrawn from the total Rp26 trillion owned by government-owned companies. The measures taken by Bank Indonesia for two days in a row had caused scarcity in liquidity for many banks. And on August 29th, the government restricted forward selling transactions of foreign currency (against rupiah) from the local banks to nonresident (foreigners) customers, for a maximum transaction per customer and position per bank of U.S.$5 million, except swap transactions for investment purposes in Indonesia and for export-import.

Bank Indonesia tried mopping up liquidity with high interest rates. Most market players welcomed the central banks move, saying that it would stabilize the currency. Some other analysts, however, question the medium-term effectiveness of the US$5 million cap, since the ruling was applied to banks based in Indonesia, whereas in terms of volume, the rupiah trading in Singapore was considerably more significant than in Jakarta. "They just pushed the panic button, propping up interest rates just killed economic activity" an investment fund manager said of the central bank.

The rupiah sank still further, it fell 4.5% on the day.[41] Now, the rupiah's plunge seemed an inevitable outcome, given the domino-like tumbling of other Southeast Asian currencies. "Rightly or wrongly, this region is seen to be integrated; there is a block mentality," says Michael McNertney, managing director at Chase Manhattan Bank in Jakarta.[42] Once the currency of its neighbors dropped, it was inevitable that for competitive reasons Indonesia would let its currency go as well. In August the baht had fallen further down, 34% below its beginning of the year value. This large effective real depreciation of the baht put firms in Indonesia, Malaysia and the Philippines at serious risk and led to rapid currency deprecations of these currencies in August. By the end of the month, the rupiah had fallen by 27% (relative to start 1997).

The same scenario of competitive devaluation of one country inducing further devaluation of other ones continued in September, and by the end of the month the rupiah was 37% below its start 1997 level. The sharp devaluation of the currencies in the region in July and August 1997 was also the result of the very loose monetary policies of the central banks in the region, before and after the currencies started to fall. The first reaction of the monetary authority to speculative pressures on the currency was to

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[41] *Financial Times, Timetable: Countdown to crisis, January 13, 1998.*

[42] *Henny Sender, Thorny Hedge, Far Eastern Economic Review, August 28,1997.*

try to avoid a monetary contraction and significantly increased domestic interest rates. When the first pressures started, the reaction was to perform sterilized interventions, and once such interventions turned out to be ineffective given their sterilized nature, several countries introduced limited (and eventually ineffective) capital controls to prevent the capital outflows.[43]

The basic stance of monetary policy in the region remained quite loose well into the crisis, and monetary authorities tried to prevent an increase in domestic interest rates from occurring. It was only when the fall of the currencies accelerated in the fall that a serious monetary tightening implemented. The policy stance of the central bank in Indonesia was motivated by the concern that high interest rates would lead to a worsening of the financial conditions of highly indebted banks, financial institutions and corporations. However, the serious policy dilemma faced by the monetaries authorities (i.e., tighten interest rates, prevent a devaluation, but bankrupt banks and firms and cause a recession or keep interest rates low to save shaky banks and corporations but risk a currency attack) was caused itself by the reckless overborrowing and overlanding that had occurred in the years before the crisis.[44]

Around this time, speculators attacked the Hong Kong dollar. The IMF unveiled a rescue package for Thailand including loans totaling $17.2 billion from the IMF and Asian nations and approved a $3.9 billion credit for

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[43] *Giancarlo Corsetti-Paulo Pesenti-Nouriel Roubini, What caused the Asian currency and financial crisis?, p.59, Nouriel Roubini homepage, March 1998.*

[44] *Giancarlo Corsetti-Paulo Pesenti-Nouriel Roubini, What caused the Asian currency and financial crisis?, p.60, Nouriel Roubini homepage, March 1998.*

Thailand on August 20. Malaysian PM, Mahathir Mohamad, blamed U.S. financier, George Soros, for leading an attack on East Asian currencies. The forest fires in some parts of Indonesia, according to official estimates, had so far swept through more than 80,000 hectares in Sumatra, Kalimantan, Sulawesi, and Irian Jaya, with the potential to spread to 300,000 hectares, and its haze affected neighboring countries.

The value of the rupiah was Rp3,055 against the U.S. dollar on Friday August 30, before paring losses back to Rp2,935 on market closing. The Jakarta Stock Exchange tumbled by 6.9% to 493.96 index levels, the lowest since December 1995. The index had fallen 11% in two days and lost 14% in a week, while benchmark stocks had fallen 32% so far this year. The inflation rate in August was 0.88%, caused by the increase in the food indices by 1.05%, housing by 0.54%, clothing by 0.50%, and miscellaneous indices by 1.07%. The inflation rates from January to August were 4.08%. Some analysts were concerned about two inflationary factors facing the economy in the near term: the drought (expected to have its greatest impact on food availability and prices next January and February) and the coming of the first day of Ramadhan (the Muslim fasting month) on 31 December 1997. Indonesia's trade surplus rose 64% to $1.45 billion in August 1997 from last year. This was the highest surplus in the last five years. The total trade surplus from January to August 1997 reached $6.4 billion, up 91% from the same period last year.

3. September 1997

On September 3, the rupiah was under pressure and the stock exchange started to slide. Indonesia announced a reform package, designed to restore market confidence. Long a favorite of the International Monetary Fund for its conservative monetary policy, Indonesia appeared ready to please again. It froze a wide range of infrastructure projects, as part of a broader effort to cut government expenditure and help bring down the current account deficit. It promised far-reaching banking reform, and for the first time, it would shut down insolvent and undercapitalized banks. The government said it would raise luxury taxes to reduce non-essential imports while reducing import tariffs for raw materials needed by exporting industries, such as textiles. It lifted a 49% ceiling on foreign share purchases on Indonesian stocks, leading to a 11% surge in the Jakarta Stock Exchange Index.

In the short run, the Indonesian governement pledged gradually to ease liquidity and interest and interest rates. The government slackened liquidity by decreasing the SBI interest rate for one month from 39% to 27%, and for three months it decreased from 28% to 25%. The Minister of Finance, Mar'ie Muhammad, stressed that the interest rate would periodically decrease, according to circumstantial developments. On September 16, Mar'ie Muhammad released more concrete plans to freeze infrastructure projects, including power plants and toll roads. Indonesia said it would postpone projects worth 39 trillion rupiah in an attempt to slash the budget shortfall. Of all government-owned companies and private projects related to government/BUMN, which were funded by commercial credit amounting to Rp161,78 trillion, Indonesia would postpone projects valued at Rp38,92 trillion, and reschedule projects valued at Rp62,69 trillion.

On September 17, the government, through the Minister of Finance Decree NO. 477/KMK.01/1997, reduced import tariffs for 153 items; 40 tariff items for textile products, 67 tariff items for wood processing, 31 tariff items for chemical products, 9 tariff items for leather products, and three each tariffs for steel, machinery's, and automotive and agricultural products. The range of tariff decrease was 5% to 10%.[45] Demonstrating how serious he was about reducing the current-account deficit, President Suharto issued a decree on September 22 postponing 81 infrastructure projects worth more than US$17 billion.

This time around, however, the Jakarta stock Exchange dipped on the news. Brokers said they were more concerned with the problem at the heart of the currency crisis-high interest rates and mounting short-term foreign debt, built up by private enterprises, much of it unheeded. Poorly reported, the offshore borrowings surfaced only as a topic when the depreciation of the Indonesian currency boosted their value in rupiah terms. Private debt had been estimated at $55 billion, but many brokerages feared this figure could be $20 billion to $50 billion higher, with much of the additional debt in short-term commercial paper.

"Investors were looking for a clear picture in terms of how they were going to deal with them," said Paul Shang, head of investment banking in Asia for Lehman Brothers. The government never gave this picture, and Mr. Soedradjad Djiwandono conceded that he simply had no idea. Nothing the government could do would make these debts disappear.[46] Suddenly, Indonesia was no longer the good boy in the class. Domestic and foreign investors alike rushed for the exits. Local companies started lobbying for a more rapid reduction of interest rates, without much effect. And even if official lending rates were coming down, few banks were actually lending. Indonesia saw its first defaults.

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[45] *KK and Andi Zulfikar, Strategy to safe rupiah, Gatra Number 48/III, October 18,1997.*

[46] *Sander Thoenes, Indonesia: The offshore borrowing trap, Financial Times, January 12, 1998.*

Around this time, because of drought and clearing lands by some companies, the massive forest fires were chocking the archipelago, drought was worsening and President Suharto's unprecedented apology for the forest fires that were spewing smoke over neighboring Malaysia and Singapore had drawn praise as a sign of Indonesia's readiness to tackle the annual haze. Malaysia sent 1,200 firefighters to join the assault, Singapore was contributing satellite data, Japan offered pumping equipment and water-jet shooters, and Thailand was sending two fire-fighting planes. According to data obtain from the Ministry of Agriculture, the drought had hit over 301,000 hectares of rice fields, as of early September of which 32,600 hectares were completely destroyed.

The government set up emergency rice stocks across the country to deal with expected food shortages caused by drought. The problem was especially severe in Irian Jaya province, where 251 deaths had been reported due to cholera and famine, which had affected more than 5,000 villages in the province. BULOG had said that so far there was no need to import rice. The Minister of Agriculture, Sjarifudin Baharsjah, said that there would be no shortage, since the government had enough rice stocks to cover four to five months consumption.

Malaysian PM, Mahathir Mohamad, told delegates to the IMF/World Bank annual conference, on September 20-21 in Hong Kong, that currency trading was immoral and should be stopped. And George Soros said "Dr. Mahathir is a menace to his own country." At the end of the month, the value of the rupiah was Rp3,289 against the U.S. dollar. Most analysts believed the weakening was triggered by corporate demands for the U.S. dollar, as the deadline for certain obligations were nearing. Some other analysts said the fall in regional currencies could also have been triggered by yet more negative remarks made by Malaysian Prime Minister Mahathir

Mohamad during his visit to Chile. Mahathir reiterated his contempt for currency speculators and said trading in the Malaysian ringgit should be regulated.[47] Foreign Investment Approvals fell 2.1 in the January to September period to US$24.09 billion compared with the same period in 1996. Domestic investment approvals during the same period rose to Rp91.3 trillion from 546 projects, compared to Rp82.5 trillion from 646 projects previously. The inflation rate in September was 1.29% and was caused by the increase in the food indices by 1.91%, housing by 0.82, clothing by 0.61, and miscellaneous indices by 1.29%. Cumulative inflation rate by the 1997 calendar year (January-September) reached 5.3%.

4. October 1997

On October 3, The Governor of Bank Indonesia, with Minister of Trade and Industry, announced an award of swap facilities to exporters and forward buying facilities for imports related to export activities. These facilities were offered to attract foreign currencies from exporters and to provide fixed rates to business communities. Between October 6-8, Bank Indonesia made three market interventions for an estimated value of US$650 million. Financial analysts marveled at how quickly sentiment has shifted against Indonesia. A stock market index fluttering at the 700 level in early August was now struggling to stay above 500. After the rupiah sunk to a new low of Rp3,845 against the dollar on October 6, 1997, Indonesia realized it lacked the means to restore confidence in the rupiah and its economy.

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[47] *Indonesian Business: The Year In Review 1997, Chapter 2 - Macroeconomic, The Castle Group Business Information.*

On October 8, 1997, Indonesia asked the IMF, World Bank and Asian Development Bank for advice and financial assistance in restoring confidence and warding off further attacks on the currency. The IMF agreed to send a technical team to Indonesia to begin developing an economic restructuring program and a financial assistance package. IMF Managing Director, Michel Camdessus, said that Indonesia's fundamentals were basically sound, which indicated that an IMF package would be limited to a stand-by facility rather than any direct emergency loans. At the same time, the government had reaffirmed its commitment to a free foreign exchange system and said that no exchange controls were planned.

Meanwhile, the Minister of Finance, the Governor of Bank Indonesia, and the Minister of Industry and Trade had also been conducting closed door meetings with major portfolio investors, which included some of the world's leading fund management companies, such as Quantum, Templeton and Capital International. Sources close to fund managers said the mood was still somber, although most were aware that "Indonesia is not a basket case." The rupiah seemed to have stabilized between Rp3,450 and Rp3,550 for the time being, but continued volatility was to be expected. President Suharto assigned Widjojo Nitisastro, the dean of New Order financial advisors, to coordinate and take necessary action in handling the monetary crisis.

In late October, Japan and Singapore pledged $10 billion ($5 million apiece) aid to Indonesia and Malaysia, despite its own financial problems, pledged $1 billion. The pledges came as Jakarta pursued difficult negotiations with the IMF on conditions for aid, and allowed President Suharto to declare that he needed only expertise and not money from the fund.[48] Australia also pledged $1 billion.

On October 31, 1997, Indonesia's IMF package was unveiled in Jakarta. It provided for as much as $40 billion in financial assistance, including a front-line defense fund of $23 billion. Indonesia agreed to close 16 insolvent banks, reduce import tariffs, deregulate several commodity products, open its domestic wholesale and retail markets, postpone several large infrastructure projects, and implement other economic reform measures. The IMF package included a commitment from the United States of $3 billion in the form of second-tier defense loans and bilateral credits. Confidence was partially restored.

When news of the IMF package for Indonesia broke on October 28, the rupiah strengthened against the U.S. dollar. (It was helped by concerted intervention by Japan and Singapore, which both bought rupiah heavily).[49] At the heart of Indonesia's financial crisis was corporate debt. The biggest part of the debt problem was the unregulated, very-short-term commercial paper market-U.S. dollar borrowing on terms typically between one and three months. Standard & Poor's had lowered its long-term foreign currency rating on Indonesia to triple B minus from triple B. Standard & Poor also lowered its long-term local currency rating on Indonesia to single A minus from single A plus. In the meantime, Moody's Investors Service said Indonesian corporations and banks were likely to experience significant problems as a result of the country's currency depreciation.

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[48] *Michael Vatikiotis, Pacific Divide, Far Eastern Economic Review, November 6, 1997.*

[49] *John McBeth, Big is best, Far Eastern Economic Review, November 13, 1997.*

Around this time, the smog was still sweeping across Southeast Asia from forest fires in Indonesia. The smoke choking the region had prompted unusually blunt criticism of Indonesia from Asian countries that normally treated the group's largest member with deference. The degree of anger in Malaysia and Singapore had forced their governments to be more critical of Jakarta. In response to growing regional resentment, President Suharto on October 5 issued another apology to his neighbors, his second in three weeks. He also ordered the military to step up their efforts to fight the forest fires.[50]

In others countries, on October 17, Taipei abandoned its defense of the New Taiwan dollar. The South Korean won slumped rapidly in value against the U.S. dollar and bankruptcies threatened a debt crisis. In Hong Kong, several hedge funds decided to see how far they could push the Hong Kong unit from its tight, 14-year-old peg of around 7.80 to the U.S. dollar. The Hong Kong stock market suffered its heaviest drubbing ever. On October 23, the Hang Seng index was down 23.34% to 10,426.30, and on October 27 the Hang Seng lost another 646.14 points, or 5.80% to 10,498.20. The loss rippled through global markets. Asian jitters spilled over to the world stock market.

On Wall Street, the Dow Jones industrial average posted its single-biggest point loss ever, falling 55.26 points or 7.18% to 7,161.15. The Nasdaq plunged 115.43 points and the S&P index tumbled 64.65 points. The decline was so steep it prompted stock exchange officials to suspend trading. Stock markets throughout Latin America suffered record losses as Asia's market crisis rippled to other vulnerable emerging markets and investors frantically sold their holdings. During October in many Asian countries, there was a growing

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[50] *Murray Hiebert and John Mcbeth, Trial by Fire, Far Eastern Economic Review, October 16, 1997.*

feeling that Washington was neglecting the region in its time of dire need. There was no Mexico-style bailout offer or other substantial pledges of aid. Washington's muted response to the currency crisis sweeping Southeast Asia was sowing suspicion among its allies in the region and fuelling anti-American sentiment.[51]

At the end of the month, the rupiah value was Rp3, 630 against the U.S. dollar. The deflation rate of 1.99% in October was caused by the increase in all indices. The food expenditure index was up by 3.61%, housing index by 1.18%, clothing index by 2.35%, and the miscellaneous index by 0.65%. Consumer prices in October were up 1.99% from September and up 8.8% year-on-year. The October increase was the largest monthly rise in a decade, said Information Minister R. Hartono.

5. November 1997

In an effort to salvage the country's teetering financial system, on November 1, 1997, Indonesia closed 16 of it weakest banks. That was enough to prompt panicked citizens to pull funds out of the system. The move had frozen the savings of thousands of people and cost 6,000 bank employees their livelihoods. The bank closures ensured that the package had the desired shock value, because of the almost deliberate way the government homed in on big-name owners. "The list is odd because there are so many high-flyers, surely these are not the worst 16 banks" said Eugene Galbraith, group head of research for ABN-Amro Hoare Govett Asia.[52] With as many as 25 or so other problem banks

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[51] *Michael Vatikiotis, Pacific Divide, Far Eastern Economic Review, November 6, 1997.*

[52] *John McBeth, Big is best, Far Eastern Economic Review, November 13, 1997.*

believed to be facing the possibility of mergers or bankruptcy, account holders at even the country's largest private institution, Bank Central Asia, were pulling out and heading for the safety of state banks. Most customers at the closed banks, particularly small savers, would get their money back.

Many protesters were gathering with economic rallying cries, as the pain of the financial crisis started to bite. Some feared that large numbers of workers would take to the streets, as the effects of the economic crisis hit home. As in the last situation, Indonesia had often been described as a simmering volcano; some feared that the latest tensions could make the mountain blow its top.[53]

Fifteen delayed infrastructure projects had been given the go-ahead from the government. This decision came only weeks after all were postponed, along with another 135 infrastructure projects in the wake of the currency crisis. The 1 November decree said the status of the 15 projects had been changed, in accordance with the results of a government study. On November 5, 1997, the IMF approved a $10 billion loan for Indonesia, as part of the massive international package.

On November 18-19, 1997, the Deputy Finance Ministers meeting in Manila (12 Asian finance ministries, plus the U.S. and Canada, The IMF, the World Bank, and the Asian Development Bank) issued a statement that proposed the formation of a new mechanism to enhance the IMF's role in identifying possible financial crises in Asia and addressing them when they happened. The framework for cooperation would include meetings at least twice a year, but it did not mention specific participants in the new mechanism. By the end of the two-day Manila meeting of deputies, no hard

[53] *The Next Battle, Far Eastern Economic Review, November 20, 1997.*

numbers emerged for the possible size of financing arrangements that would always be supplements to the resources put forward by the IMF.

On November 22-24, 1997, President Soeharto discussed Indonesia's economic restructuring program with President Clinton at the APEC economic leaders meeting in Vancouver, Canada. The Asian financial crisis was a lead agenda item at the APEC meeting, but the leaders reached no policy decisions. The 18-member Asia Pacific Economic Cooperation Forum ended an annual summit with a call for greater trade freedom and common front against the economic turmoil gripping the region. This year's summit had been overshadowed by economic crisis in East Asia and fears over Japan's ability to spearhead a recovery. The APEC leaders said it was critically important to act quickly against the Asian turmoil.

The Singaporean and Indonesian monetary authorities had clarified confusion caused by Aburizal Bakrie's statement on the nature of Singapore's financial assistance to Indonesia. After an audience with President Suharto, Bakrie publicly stated that Indonesia wanted to use US$5 billion in bilateral loans from Singapore to ease market liquidity. He said that the funds would be linked to small-scale business, cooperatives, labor-intensive industries and exports to be channeled by the Indonesian Chamber of Commerce and Industry (Kadin), which Bakrie chaired. Soon after the Bakrie intervention, Singaporean and Indonesian officials clarified the situation. In fact, Singapore's US$10 billion package consisted of US$5 billion to help stabilize the rupiah and another US$5 billion for balance of payment support, according to a Bank Indonesia statement.[54]

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[54] *Indonesian Business: The Year In Review 1997, Chapter 2-Macroeconomic, The Castle Group Business Information.*

Around this time, a grey-brown haze still blanketed some part of Indonesia and its neighbors. Millions of inhabitants had to resort to surgical masks before venturing into an outside that has been shrouded in an eerie, almost-perpetual twilight. The haze had been attributed to forest and bush fires that began from open burning to clear land and the prolong drought caused by the El Nino effect. In Thailand, Prime Minister Chavalit resigned on November 6 and was replaced by Chuan Leekpai on November 9.

In South Korea, on November 10, the Korean won closed at 999 to the U.S. dollar, pushing the rate that ordinary Koreans paid for dollars at banks to more than 1,000 for the first time ever. South Koreans called it `the four-digit' era. On November 17, South Korea abandoned its defense of the battered won, sending the currency smashing through the psychological 1,000/dollar level. "The plunging won has put the spotlight on South Korea's economic weaknesses and raised fears of a Southeast Asia-style meltdown, that would hurt Japan, Taiwan and more besides. There's a growing fear that it may become the next domino to fall to the financial turmoil shaking its Southeast Asian neighbors. If that happened, the consequences would reverberate not only through Asia but also around the globe."[55] On November 21, South Korea, buckling under the pressure of a slumping currency and crumbling investor's confidence said it would seek a rescue package from the IMF. Most regional currencies fell sharply following the fall in the Korean won. Relative to the U.S. dollar, the Indonesian rupiah fell 1.0% on November 18 and by 1.86% on November 20.

In Japan, on November 12, the benchmark Nikkei 225-share index fell to its lowest level in more than two years, as the yen slid against the U.S. dollar. The Nikkei

[55] *Charles S. Lee, The Next Domino, Far Eastern Economic Review, November 20, 1997.*

finished 2.73%, or 433.06 points lower at 15,434.17, amid rising concerns about the health of the financial system supporting the world's second-largest economy. The failure of the Hokkaido Takushoku bank on Monday November 17, the first of Japan's big banks to collapse under the weight of bad loans, was the latest strongest sign yet that the Japanese government was prepared to allow market forces to reconfigure the domestic financial landscape. On November 24, Japan's fourth-largest brokerage, Yamaichi Securities, announced it would shut down, casting a spotlight on the continuing woes of the country's troubled financial sector. The 100-year-old firm was one of Japan's Big Four brokerages. Its failure was Japan's largest financial debacle ever and the third financial institution to close this month. Yamaichi said that the massive weight of its 3 trillion-yen ($23.6 billion) in debt brought about the downfall. News of the closure of Yamaichi Securities rocked financial markets. The events in Japan were gradually being factored into the regional currencies. The downturn that killed Yamaichi offers a cautionary tale for the rest of Asia, where most countries face the bursting of their own bubble economies, exposing weak, poorly regulated financial systems.[56]

At the end of the month, the value of rupiah was Rp3,645 against the U.S. dollar. The inflation rate in November was 1.65% and reflected an increase in the food indices by 3.66%, housing by 0.54%, clothing by – 0.19%, and miscellaneous indices by 0.79%. Cumulative inflation rate by the calendar year (January-November) reached 9.01% and cumulative inflation rate by the 1997/1998 fiscal year (April-November) was 7.05%.

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[56] *Peter Landers and Dan Biers, This Will Hurt, Far Eastern Economic Review, December 4, 1997.*

6. December 1997

On December 5, Indonesia's rupiah hit a record low of Rp4,020 to the U.S. dollar, as traders shrank from Southeast Asian currencies. However, the country's central bank came to the rescue, selling off dollars and stabilizing the rupiah at Rp3,965. On December 8, workers trapped in a burning office tower of Indonesia's central bank yelled for help and waved red cloths, as flames gutted the building's top three floors, killing 15 people. Faulty electrical wiring may have caused the fire in the new 25-story Bank Indonesia building in central Jakarta, a fire official said.[57] The fire was another crisis for the central bank, which had been at the center of efforts to prop up Indonesia's ailing currency. The rupiah promptly slid further to Rp4,155.

On December 9, rumors that Indonesia's President Suharto was gravely ill swept Southeast Asian currency markets, sending the rupiah into a tailspin. Senior ministers' assurances that the 76-year-old president was in good health and merely resting on the advice of his doctors were unable to prevent the currency from crashing 10% against the U.S. dollar. By the close of Asian trading, the rupiah had dropped to an all-time low Rp4,625 to the U.S. dollar, down from Rp4,141 late Monday, and 47% below its value just five months ago, before the Asian currency crisis struck Indonesia.

At present, a regional currency crisis, a severe drought and a serious loss of confidence among investors beset Indonesia. Some economists predicted that the number of people in poverty could soar in 1998. Some agricultural economists worry that supply may be short, so prices could

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[57] *John McBeth, Flame Out, Far Eastern Economic Review, December 18, 1997.*

soar next year. Many observers say it comes down to confidence, and the IMF rescue package agreed to in October has not boosted confidence as hoped. One major problem, they asserted, was that Indonesia had sent mixed and confusing signals about policies. For example, the government stopped dozens of planned infrastructure projects, but then allowed 15 of them to proceed. In another case, businessman Aburizal Bakrie created confusion when he said last month that the president had told him five billion U.S. dollars in aid from Singapore could be lent to private companies but a week later State Secretary Murdiono said this was not the case. (President Suharto himself never made any public comment).[58]

In order to try to boost shattered confidence, on December 10-12, 1997, Indonesian finance minister, Mar'ie Muhammad, traveled to Washington and New York to meet with the U.S. officials, the IMF and business and banking leaders. On December 12, Indonesia stocks plunged 7.6% and the nation's currency, the rupiah, sank on Friday, as concerns resurfaced about the health of President Suharto when it was reported on the news that he would not attend an Asian summit next week after all. Assurances earlier in the week that the president would travel to Kuala Lumpur for the Southeast Asian Nations Summit had helped to stabilize Indonesia's markets. But on Friday, official word emerged that president Suharto would heed the advice of doctors, who urged him not to make the trip.[59]

The reaction in the market was swift. It caused the rupiah to nosedive to Rp5,800 per U.S. dollar on December

[58] *Nouriel Roubini, Chronology of the Asian Currency Crisis and its Global Contagion, 1997,* *http://www.stern.nyu.edu/~nroubini/asia/AsiaChronology1.html*

[59] *Imam B. Sarjito, Economic Brief, BNI Securities equity research, January 1998.*

15, representing a depreciation of around 11% in a single day. The Jakarta Stock Exchange index lost 30.255, or 7.6%, to 365.853. Before the Friday announcement, the currency had already slumped amid fresh rumors about President Suharto's health. This was supported when the President canceled a visit to his wife's grave in Solo, Central Java, which was to be made in accordance with the Indonesian custom of visiting the graves of relatives before the Muslim fasting month.

Within minutes of the disclosure, panic selling sent the currency crashing through the key psychological barrier of Rp5,000 to the U.S. dollar. Late in the day, the Indonesian currency was traded at around Rp5,150 to the U.S. dollar, compared with Rp4,580 to the U.S. dollar late on Thursday an 11% devaluation. The rupiah was down 22% for the week and 54% for the year, making it the worst performing currency in the region so far this year.

The currency freefall had led to predictions by some economists that Indonesia would experience a recession next year, as the rupiah's plunge placed an impossible debt-servicing burden on Indonesian corporations. That would be the first contraction in growth since 1965, and raised fears of social unrest. These worries were starting to dwarf previous concerns about Indonesia's commitment to the economic reforms mandated by the IMF, as part of its $40 billion bailout.[60] On December 22, 1997, Moody's Investor Service, the U.S. credit rating agency, downgraded Indonesia's credit rating to Ba1 (to junk bond status) including South Korea, Thailand, and Malaysia. The IMF revised down its estimate of 1998 world economic growth from 4.3% (made in October 1997) to 3.5%, recently due to the prolonged Asian currency turmoil. With respect to

[60] *Nouriel Roubini, Chronology of the Asian Currency Crisis and its Global Contagion, 1997.*

Indonesian economy, the IMF revised its 1998 growth estimate from 6.2% to only 2.0%. This seemed to be related to the tumbling of the Indonesian rupiah, which broke the 5,000 level against the U.S. dollar representing a rupiah depreciation of around 55% in less than six months. This sharp depreciation of the rupiah has increased the cost of production, pushing up inflation, and driving up domestic interest rates. In turn, this would likely cause a slow down in the growth rate of investment and consumption in 1998.[61]

On December 24, the rupiah plunged to a new record low, as domestic demand for dollars again reached panic levels on reports that the country's short-term debt burden was higher than previously thought. After falling as far as Rp6,300 to the U.S. dollar from a Tuesday closing of Rp5,450, the currency bounced back after reports of late afternoon intervention by Bank Indonesia, the nation's central bank, trading late Wednesday in Asia at around Rp5,750 versus the U.S. dollar. But analysts said the currency may head still lower in coming days.

In addition to worries about the short-term debt burden faced by Indonesian companies, the rupiah was hurt by the recent downgrades of Indonesian debt by major rating agencies. The downgrades heightened fears international banks would be unwilling to roll over their loans to the corporate sector. What was needed, analysts said, was more evidence that the government was prepared to take serious steps to control the crisis such as measures to create more competition in the financial sector and open up the property market to foreign investment.

Little new has emerged since Indonesia implemented some reforms after turning to the IMF in October for a near $40 billion bailout. The market had been hoping for substantial

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[61] *BNI Securities, Daily - Economics, December 22, 1997.*

policy news at a cabinet meeting headed by President Suharto. But the meeting proved a disappointment for the markets yielding little more than a request for Indonesians to refrain from buying imported items. And the threat from Indonesia's debt obligations was apparently much worse than initial projections, according to a December report by the European investment house Indosuez W.I. Carr Securities. Indosuez estimated that the total Indonesian debt was likely to be closer to $200 billion, as opposed to the Indonesian government's official figure of $117 billion. Indosuez estimated that at least $44 billion in offshore bond borrowings was not included in the official government figures, nor were short-term, offshore borrowings.

The fear that international banks would not roll over their loans after the Moody's downgrade spurred Indonesian companies to buy dollars, even at exorbitant rates. According to Bank Indonesia, US$9.6 billion of Indonesia's private debt would mature by March 1998. In order to pay their debts, many entrepreneurs had changed their rupiah holdings into dollars. This action had considerably boosted demand for dollars in the market, while demand for the rupiah had continued to shrink. Unfortunately, hardly any of the private entrepreneurs safeguarded their debts by hedging. Hedging involves buying dollars when entering transactions with the overseas party at the prevailing rate of exchange at that time, so as to safeguard their loans. Hedging is vitally important, given that, as Sofyan Wanandi said, most of Indonesia's private sector overseas debt was taken out when that dollar was still at Rp2,400. Just imagine the losses incurred by the private sector now that they have to pay off their debts with the dollar valued at

Rp5,500 meaning they have to pay off more than twice the original loan, not including interest.[62]

The hopes for new reform would now likely focus on President Suharto's January 6, 1998, budget speech, analysts said. The market seems to be still waiting for a clearer sign from the government regarding further concrete and necessary steps that will be taken to restore confidence on the rupiah. The acceleration in implementing Indonesia's promises of reform and further efforts to improve the lack of transparency would likely be able to boost confidence. Nevertheless, political uncertainty was expected to continue for a few more months in 1998, keeping the rupiah volatile during that period.[63]

In addition, the capital market regulator, Bapepam, said the government would unveil 15 new regulations Friday in a bid to bolster the sentiment on the country's sagging capital market. Market speculation had focused on a possible liberalization of the nation's financial services sector and a reduction in barriers to foreign ownership of property. They were also looking for a government action plan for dealing with corporate insolvencies.[64] On December 26, the rupiah extended its morning gains on talk of central bank intervention. It stood at Rp4,975/5,005 to the U.S. dollar against Rp6,125/75 late on Wednesday.

Dealers said Bank Indonesia sold dollars for rupiah from the 5,650 to boost the rupiah further. But the short-

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[62] *Any TH, Private Debt:Is This Behind the Rupiah Crash, Tempo Interaktif, Edition 42/02 - December 20,1997.*

[63] *Imam B Sarjito, Economic Brief, BNI Securities Equity Research, January 1998.*

[64] *Nouriel Roubini, Chronology of the Asian Currency Crisis and its Global Contagion, 1997, http://www.stern.nyu.edu/~nroubini/asia/AsiaChronology1.html*

end swap remained below par due to persistent demand for dollars in very thin markets, keeping the rupiah vulnerable to fresh falls through 6,000, dealers said. "Dollar/rupiah could still test new highs over the reference holiday period. It really is a demand and supply situation and the demand is on the dollar,"a U.S. bank dealer in Singapore said. Dealers said transactions were hampered after non-domestic banks reduced credit lines to local banks following a Moody's Investors Service rating downgrade of Indonesian debt to non-investment grade on Monday. They said the move triggered some follow-through by local banks, which slimmed down lines to other local banks.

Around this time, in South Korea, the government officials and the IMF Managing Director, Michel Camdessus, signed a letter of intent on Wednesday, December 3, covering an international accord to provide South Korea, the world's 11^{th}-largest economy, with \$57 billion to help dig it out of its financial mess. The agreement brought an end to weeks of tension that had gripped financial markets. A record loan package led by the IMF to bailout South Korea helped calm jitters in most regional markets, but many South Koreans reacted with humiliation and anger to the deal, even though it had breathed new life into the country's ailing economy. The militant Korea Confederation of Trade Unions promised to wage "all-out strikes" if companies pushed for layoffs as a result of concessions to the IMF.

South Korea was desperate for assistance because of a ticking time-bomb in the form of its short-term debt, the reason it called in the IMF. South Korean media reported that the central Bank of Korea had been forced to pay \$10 billion in short-term foreign debt on behalf of Korean banks over the last few days. About \$66 billion of Korea's estimated \$120 billion in foreign debt was short-term, and about \$20 billion was due at the end of this year, analysts said. The IMF package for South Korea was its biggest rescue effort to date, exceeding the $50 billion rescue program for Mexico in early 1995. Similar IMF packages were provided recently for Thailand and Indonesia. Thailand received $17.2 billion and Indonesia $40 billion under IMF-led rescue that also involved offerings from other countries.

On December 18, fed up with their economy's freefall, voters in South Korea elected longtime dissident Kim Dae Jung to serve a five-year term as president, leaving some concerned that the country's financial markets would be further battered. Ripples from South Korea's economic crisis spread throughout Asia, Asian stock markets wilted from the contagion effect. South Korea's escalating financial crisis sent currencies and stock prices across the rest of Asia reeling. Traders said equity investors throughout the Pacific Rim could not afford to ignore the economic meltdown currently occurring in South Korea. They also feared that the won's swan dive might spark another debilitating round of competitive depreciation throughout Asia.

In Japan, as the year drew to a close, in a desperate bid to jump-start the economy, the government announced deregulation of several sectors and granted foreign investors better access to the market. The ensuing series of disclosures of banks' bad debts raised the specter of a major crisis whose impact could be worldwide.

During this month, the monetary stability in Asia was short-lived, as most currencies showed renewed volatility on a variety of regional concerns. Asian currencies were mostly weaker after Moody's Investors Service downgraded the sovereign debt of four countries, lowering three of them to junk bond status. (See Table 3.9) Moody's said it had downgraded the foreign currency ceiling for bonds and bank deposits of Indonesia, Malaysia and South Korea in view of Asia's continuing financial woes. It also downgraded

Thailand's foreign currency ceiling for bonds and confirmed the ceiling for bank deposits. The ratings agency attributed the moves to concern about Seoul's near- term foreign currency financing needs, the ability of Indonesia's corporate sector to meet overseas foreign debt obligations, given the rupiah's drop of over 50% and Malaysia's increased vulnerability to financial instability in the region. Moody's confirmed the foreign currency ceiling for bonds and bank deposits of China, Hong Kong, Japan, Singapore, Taiwan, the Philippines and Vietnam.

At the end of the month, the value of the rupiah was Rp5,287 to the U.S. dollar. The rupiah has depreciated by 33.7% during December, bringing the cumulative July to December depreciation to 55.8%. The inflation rate in December was 2.04%, reflecting an increase in food indices by 3.55%, housing by 0.88%, clothing by 2.10%, and miscellaneous indices by 1.48%. The cumulative inflation rate by calendar year (January-December) in 1997 reached 11.05%. The cumulative inflation rate by 1997/1998 fiscal year (April-December) was 9.09%. The 1997's inflation rate was significantly higher than that of 1996 (6.47%), and in fact was the highest yearly inflation during the last 14 years. Despite current instability in the monetary sector, approved Foreign Direct Investment (FDI) in 1997 remained high, exceeding that of 1996. From January to mid December 1997 total FDI had reached US$33.8 billion, representing an increase of around 13% from US$29.9 billion approved in 1996.

Table 3.9. Market Creditworthiness

Moody's and Standard and Poor's Long Term Debt Ratings 1996-97

	Jan. 15, 1996		Dec 2, 1996		June 24, 1997		December 12,1997	
	Rating	Outlook	Rating	Outlook	Rating	Outlook	Rating	Outlook
Moody's (Foreign currency debt)								
Indonesia	Baa3		Baa3		Baa3		Baa3	
Malaysia	A1		A1		A1		A1	
Mexico	Ba2		Ba2		Ba2		Ba2	
Philippines	Ba2		Ba2		Ba1		Ba1	
South Korea	A1		A1	Stable			Baa2	Negative
Thailand	A2		A2		A2		Baa1	Negative
Standard & Poor's							Oct. 97	Oct. 97
Indonesia: Foreign currency debt	BBB	Stable	BBB	Stable	BBB	Stable	BBB-	Negative
Domestic currency debt			A+		A+		A-	Negative
Malaysia: Foreign currency debt	A+	Stable	A+	Stable	A+	Positive	A+	Negative
Domestic currency debt	AA+		AA+		AA+		AA+	Negative
Philippines: Foreign currency debt	BB	Positive	BB	Positive	BB+	Positive	BB+	Stable
Domestic currency debt	BBB+		BBB+		A-		A-	Stable
South Korea: Foreign currency debt	AA-	Stable	AA-	Stable				
Thailand: Foreign currency debt	A	Stable	A	Stable	A	Stable	BBB	Negative
Domestic currency debt			AA		AA		A	Negative
Mexico: Foreign currency debt	BB		BB		BB			
Domestic currency debt	BBB+	Negative	BBB+	Stable	BBB+	Positive		

Rating Systems, from highest to lowest:
Moody's: Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3
S&P's: AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB

7. January 1998

In the beginning of the year, Indonesian economic conditions were very weak. Jakarta stocks were falling and the rupiah had plunged into an abyss. With each downward lurch of the currency, Indonesia's foreign-debt burden grew bigger. A sick President Suharto hadn't been seen in public for a week, fuelling market jitters. Perhaps half of the corporate sector would be closed by now, analysts say, if Indonesia's bankcrupty process were more streamlined. Three out of four Indonesian companies were deemed unhealthy in the Castle Group's Altman-Z test measuring the likelihood of failure. Tight money had reduced working capital to a minimum, putting bonuses and even salaries at risk. Unemployment was on the rise. The Ministry of Manpower Planning estimated that the crucial forestry industry had lost 23,000 jobs and the banking sector 16,000 since the summer 1997.[65]

Outside Jakarta, a severe drought was raising the price of agricultural goods, while reducing consumer demand from rural areas-a good recipe for recession. El Nino, a warm Pacific Ocean current that brings dramatic changes to the world's weather every few years, caused the drought. Harvest had been delayed or destroyed, with consequences that rippled through the rural economy. Some economists predicted that millions of Indonesians would be dragged back below the poverty line, reversing decades of progress. Malnutrition and infant mortality were expected to rise, particularly in eastern Indonesia. In Irian Jaya,

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[65] *Salil Tripathi, Face the Music, Far Eastern Economic Review, December 25, 1997 and January 1, 1998*

Indonesia's easternmost province, famine and malaria had killed about 800 people.[66]

On January 5, Asian currencies plunged as investors returned to the foreign-currency markets and heavily bought the dollar. Selling drove the Malaysian ringgit, the Indonesian rupiah, the Thailand baht and the Philippines peso to record lows against the U.S. dollar. At the end of Asian trading and at the start of European trading, the U.S. dollar soared to 133.00, its highest level against the Japanese yen since May 11, 1992. The dollar had traded at 132.40 late Friday in New York. The tumult in the currency market, in turn, hurt the Asian equities markets. The currency blight spread to Australia and New Zealand and gold dipped to a new 18-year low on worries about weak Asian economies and deflation. Traders said the slew of factors behind the currency declines included uncertainty over Indonesia's budget announcement Tuesday and the health of President Suharto, falling regional stock prices and worries about possible speculative attacks on other Asian currencies like the Chinese yuan and Hong Kong dollar.

On January 6, at 8:30 p.m. Jakarta time, President Suharto announced the fiscal 1998-1999 Central Government budget projecting an increase of 32.1% growth in revenue and expenditure over the current budget and four percent economic growth rate. But, this budget failed to convince investors that Indonesia was committed to reforming its economy. The rupiah plunged, on January 7-12, losing half its value against the U.S. dollar over a five-day period, breaking through the Rp.10,000 to the dollar level, before a slight recovery. The freefall was triggered by perceptions that the Central Government Budget was not tough enough to meet the IMF-mandated austerity measures and by market talk

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[66] *Margot Cohen, Unlucky Country, Far Eastern Economic Review, December 25, 1997 and January 1, 1998*

that Indonesia might declare a debt moratorium.[67] On January 8, frantic selling shredded Indonesia's financial markets, highlighting a sweeping lack of confidence in the country's economic management and contributing to a sell-off on most other Asian markets.

The meltdown in Indonesia showed no sign of abating and raised the specter of civil unrest. Indonesian stocks crashed 18.5% in mid-afternoon, before recovering to be off 11,95%, or 47.13 points, at 347.10 in late trade. The rupiah skimmed the Rp.10,500 to the U.S. dollar barrier. The plunge of 26% in a single session left the rupiah down more than 70% since the Asian crisis began last July.

All eyes were on Indonesia's hemorrhaging markets. Attention was increasingly focused on the political situation, fearing tough IMF conditions had heightened the likelihood of social unrest prior to the March presidential poll, in which president Suharto was expected to run for a seventh five-year term. "There are signs of the social aspect starting to unravel, with people calling for President Suharto to step down," said Callum Henderson, managing analyst at MMS International. There were reports of panic buying of food in some Indonesian supermarkets fearing prices would spiral up. As the rupiah went into a freefall, panicky housewives and office workers stormed supermarkets and discount stores, convinced price hikes and street violence were on the way.[68]

On January 9, concern over Indonesia hit Asian stocks, but currencies won some support on hopes of an imminent deal between U.S. banks and heavily indebted Indonesian

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[67] *Reuters, Chronology of the Asian financial crisis, February 01,1998.*

[68] *John McBeth, Ground Zero, Far Eastern Economic Review, January 22, 1998.*

companies. Expectation of some type of Indonesian debt accord intensified following telephone conversations between U.S. President Bill Clinton and Asian leaders, and a new commitment from Indonesian President Suharto to implement economic reforms. President Suharto pledged his commitment to implement economic reforms attached to a US$40 billion financial aid package negotiated last year, a significant shift after tabling an expansionary 1998/99 budget that failed to outline the economic austerity required by the IMF.

The IMF's first Deputy Managing Director, Stanley Fischer, arrived in Jakarta on January 11 for talks about the IMF's programs, additional economic reform measures, and how to move ahead with it. A senior economic adviser vowed that the nation would continue to make international debt payments. At the same time, President Suharto moved to halt or review 15 infrastructure projects. This move helped to boost confidence that the country would abide by terms of an IMF bailout package.

On January 13-15, U.S. Defense Secretary, William Cohen, and Deputy Treasury Secretary, Lawrence Summers, conferred with Indonesian government leaders in Jakarta. Cohen reiterated the important role Indonesia plays in ensuring regional security and stability. Indonesian State Secretary Murdiono said President Suharto told visiting U.S. Deputy Treasury Secretary Lawrence Summers that Indonesia would implement its economic reform program, as soon as possible. Mr. Summers left the talks saying that President Suharto recognized the need to take strong steps on economic reform to end the currency crisis. Mr. Cohen concluded "after talking with the Indonesian President, I am convinced that he is determined to put his country on a sound footing and to have a recovery of confidence in the integrity of the country's financial system."[69]

The remarks were the latest in a raft of confidence-boosting statements from U.S. luminaries trying to shore up the nation, racked by bad debt and political jitters. They helped to lift the rupiah to Rp 7,000/7,500 from an opening low of Rp8,300. Indonesia's Finance Minister said that there might be an adjustment in some of the economic reform program, as a result of the latest developments in the economy. On January 14, The IMF Managing Director, Michel Camdessus, came to Indonesia where he stressed that Indonesia must accelerate long overdue economic reforms. "The immediate priority of my visit is to arrest and turn around the tremendous loss of confidence, and stabilize the market through monetary discipline and a dramatic acceleration of long overdue structural reforms," Camdessus said.

On January 15, President Suharto and The IMF Managing Director, Michel Camdessus, signed an agreement strengthening Indonesia's economic reform program. The agreement called for significant new structural reforms, including lifting subsidies for energy, dismantling domestic trade restrictions in several industries, establishing greater independence for the central bank (Bank Indonesia), reducing selected foreign investment barriers and ending support for Indonesia's national automobile program and national aircraft program.[70]

There were also major revisions of economic forecasts contained in the recent budget, which shattered

[69] *Seth Mydans, Indonesia Agrees to Economic Reform Under Pressure From I.M.F, The New York Times, January 15, 1998.*

[70] *Indonesia's Economic Crisis - A chronology of events, http:www.indonesiatoday.com/a3/j6/y1.html#Top*

international confidence and dragged the region into a vortex. Inflation was now forecast at 20% rather than 9%, economic growth was projected at zero rather than 4%, and the rupiah rate, upon which the budget was based, was cut to Rp5,000 to the U.S. dollar instead of Rp4,000. Most important, some analysts said, was the suggestion that a one-% budget deficit had been allowed under the new calculations, implying greater latitude by the IMF on efforts by the government to stimulate real economic growth.

There were several features about the plan that look promising. Notable among them was the president's apparent commitment. Reeling after the last week's financial meltdown, President Suharto showed himself prepared to put the nation before family and friends. The President backing the plan could symbolize that this time a determined effort would be made to transparent economic management.[71] Michel Camdessus said, "I am confident that if this program is implemented with the determination and commitment that I myself have seen, Indonesia should be able soon to begin to overcome its economic crisis." And World Bank chief, James D. Wolfensohn said the reform was as broad-based as possible. "This program contains just about everything the government can do to get its economy back on track and to protect the poor from the worst effects of the economic crisis."[72] On January 16, The Clinton administration and the IMF announced strong public support for Indonesia's new economic restructuring program. Camdessus predicted the Indonesian economy would recover within two years.

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[71] *Peter Montagnon and Sander Thoenes, On the Critical List, The Financial Times, January 16, 1998.*

[72] *Raju Gopalakrishnan, Focus-Indonesia Announces sweeping reforms, Reuters, January 15, 1998.*

Instead of the expected jump, the Jakarta stock exchange slumped by 4%, and the rupiah, slid 14% to settle at Rp8,650 to the U.S. dollar. Indonesia's new economic reform package failed to impress Asian markets, with analysts saying they were still seeking proof the country would enact tough measures to pull itself out of crisis. Jakarta stocks dipped and the rupiah sagged after two days of gains, helping to take the steam out of a two-day rally that lifted the region from a selling blitz on Monday. "Things are, as yet, unchanged. People are pulling in their horns and waiting for proof," said Marshall Mays, chief strategist with Nikko Securities. Economists and traders said that the pact didn't address Indonesia's US$133 billion of debt, much of it short-term to private companies.[73]

On January 19, the rupiah tumbled more than 10%. Late in the Asian trading day, the U.S. dollar was fetching about Rp9,400, up from Rp8,450 late Friday. The outlook for Asian markets was becoming harder to predict short-term, investors said. In terms of scenarios, "everything is so volatile at the moment, one can almost justify anything," said Hugh Young, managing director of Aberdeen Asset Management Asia. A sharp drop by the rupiah or South Korea's won would have been enough to send regional stock markets reeling.

Indonesia had signaled its commitment to much-awaited bank reform with the biggest-ever merger in the nation's private sector, creating a bank with some $5.9 billion in assets. PT Bank International Indonesia and PT Bank Dagang Nasional Indonesia said they would merge with three smaller banking units (PT Bank Tiara, PT Bank Sahid Gajah Perkasa

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[73] *Jay Solomon and Kate Linbaugh, Tension Grows in Indonesian Factory Belt, Wall Street Journal, January 19, 1998.*

and PT Bank Dewaruci) to form an Indonesian mega bank.[74] Banking analysts said it was only the first such move in the sector and more mergers and consolidation were expected, as Indonesia hastened to demonstrate commitment to reforms agreed to with the IMF to rescue its ailing economy and currency.

Elsewhere, the mood was less confident. Seoul was suffering with the won falling on dollar demand to settle import deals. Singapore shares drifted lower, spooked by uncertainties in regional currencies and eroding confidence that Asia would soon start pulling out of its economic crisis. In the mean time, the perception that the IMF package for Indonesia, Thailand and South Korea had failed to stop Asia's collapse was running from Wall Street to Hong Kong. Jeffrey Sachs, director of the Harvard Institute of International Development, said the early steps of IMF intervention sometimes created more panic than calm, particularly the action of closing banks very abruptly.

On January 21, Indonesia's battered rupiah dragged most Asia markets back into a quagmire. Strength in Tokyo and New York failed to spill over to the rest of Asia, where nearly every market reacted badly to an early session plunge in the rupiah to Rp12,000 to the U.S. dollar. All Southeast Asian currencies sank, as did the South Korean won. The rupiah hurtled lower on reports that Indonesian corporates were resorting to rupiah payments on the U.S. dollar debt, the creditors were then dumping the rupiah.

Renewed political jitters added another broadside. President Suharto confirmed he would seek a seventh five-year term in office, perhaps with Minister B.J. Habibie as his vice-president. As the rumor about the vice-president

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[74] *Jay Solomon and Kate Linebaugh, Indonesian Bank Merger May be First of Many, The Wall Street Journal, January 20, 1998.*

hit the front page on January 21, the rupiah plunged to a record low of Rp11,800 to the dollar, a quarter of its value a year earlier.[75] President Suharto formally established the Economic and Financial Resilience Council to supervise and monitor Indonesia's economic reforms. The council immediately approved all of the reform mandates under Phase I of the IMF agreement. Several presidential and ministerial decrees were signed into law.

On January 22, the rupiah continued its fall a week after the Indonesian Government agreed to the new IMF-mandated reform measures. The IMF package showed no signs of alleviating Indonesia's debt and confidence crisis. The rupiah fell to a record low of Rp17,000 to the U.S. dollar at one stage, but traders said volume was small. This enabled Bank Indonesia to intervene by selling the dollar and drive the currency back to Rp11,800. Dealers said the market was still overwhelmingly in favor of the dollar due to a slew of negative developments in Indonesia.

> People just don't want to quote this currency anymore. There's still a lot of dollar buying interest from U.S. funds, Jakarta centers, everywhere. And nobody has any dollars to offer. According to a U.S. bank dealer in Singapore.

The failure of Indonesian authorities to convincingly address the country's corporate debt, estimated at $65 billion, and growing bank liquidity problems were among the factors weighing down the rupiah. Central bank governor Sudradjad Djiwandono said that the government would soon announce guidelines to resolve liquidity and solvency problems in the private banking sector. The rupiah also suffered from uncertainty over the political outlook after rumors that Research and Technology Minister, B.J. Habibie,

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[75] *John McBeth, Soaring Ambition, Far Eastern Economic Review, January 29, 1998.*

may be President Suharto's preferred vice-presidential candidate in the March polls.[76]

Most Asian currencies were dragged down by the rupiah's plunge, but at a much slower pace, as traders were turned wary of coordinated central bank intervention. The plunge in the rupiah meant that Indonesia's US$65 billion in private dollar denominated debt had swelled to exchange levels that borrowers could not afford to repay, with far more rupiah required to buy dollars than before. That had raised the possibility of mass bankruptcies or a possible moratorium from creditors on Indonesian debt payment, where some analysts estimated that all but 22 of the nation's 228 publicly traded companies had liabilities that exceed assets.[77]

On January 23, the Indonesian Government presented a revised 1998/99 Central Government budget, based on new figures agreed to between the Government and the IMF. The new budget expected zero growth in fiscal 1998 and inflation of 20%. But it also assumed the rupiah would be at a level of Rp5,000 to the U.S. dollar. It ended the day at Rp12,000. Some regional analysts argued that the current focus on Indonesia would allow other troubled Southeast Asian economies.

On January 27, at a banking meeting in Singapore, the top Indonesian officials and advisers met representatives from 20 big banks for about two hours. Radius Prawiro, President Suharto's debt adviser, Mr. Kent, and David Brougham, who is a director of Standard Chartered Bank in Hong Kong, sketched out their vision for how debt talks

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[76] *Raphael Pura and Richard Borsuk, Suharto's Likely No. 2 Man Could Stir Storm, The Wall Street Journal, January 21, 1998.*

[77] *Seth Mydans, Indonesia Currency Falls Hard, Clouding Recovery, The New York Times, January 23, 1998.*

should proceed. Indonesia announced a temporary freeze on debt servicing until a new framework was worked out between international lenders and Indonesian borrowers on how to tackle a crippling private sector overseas debt estimated at $66 billion, but said this action was not a moratorium. Companies with the dollars to pay off their creditors must continue to do so. Indonesia also announced a series of banking reforms in which the government would guarantee the security of both depositors and creditors, and commit to open the doors to foreign ownership.[78] The measures were designed to restore domestic confidence in the private banking sector, which had been suffering from a drastic liquidity crunch, as local depositors withdrew funds.

The Government created the Indonesian Banking Restructuring Agency (IBRA), which would be responsible for rehabilitating banks that were not sound or were unable to restore themselves. Banking analysts welcomed the elimination of all restrictions on overseas ownership of Indonesian banks, but some questioned the government's apparent determination to avoid the liquidation of any banks in the system.

> The Government wants to rescue the banking sector and they are buying time, "an Indonesian banking source said. "This is a very different attitude from November, the Indonesian economy would not be in the state it is in today." A senior Western banking analyst said, "I think the very positive thing is that we are seeing something come out, whether we like it or not." But, he said, more details were needed on what was covered under the government's guarantee for creditors of commercial banks.

Radius Prawiro, appointed by President Suharto to oversee the private debt crisis, estimated 228 companies in

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[78] *Darren McDermott and Jay Solomon, Indonesian Debt Plan Leaves Bankers Skeptical, The Wall Street Journal, January 28, 1998.*

the country faced problems servicing debt. The value of the rupiah had plunged around 80% against the U.S. dollar since last July, with frantic buying by corporations to cover unhedged overseas debt, sending the rupiah further down in a vicious circle. What began as a financial crisis five months ago was now having real economic consequences. Many Indonesian-based exporters, bereft of working capital and unable to import inputs, suspended production. Foreign lenders had largely ceased accepting letters of credit from Indonesian banks, hindering trade. The interbank market, where banks lend surplus funds to each other, was barely functioning.[79] The rupiah had strengthened against the dollar, but analysts said the central bank faced a very difficult period in supporting the rupiah.

On January 29, markets in the region were mostly closed for the second day of the Chinese New Year and for the forthcoming Moslem festival of Eid-al Fitr, which ends the fasting month of Ramadhan. Blissful quiet appeared to reign in Indonesia, where some currency quotations were seen but no deals reported. The rupiah on news of the economic reform plans. The rupiah was quoted at Rp10,400/10,900 to the dollar late in the day, up from Wednesday's close of Rp9,850/10,800. Calculated on the year-on-year basis, inflation in January 1998 was 18.06%, compared to 11.6% in December 1997.

The significant increase of inflation in January was due to the sharp rise in the price of foods and clothes. In January, the clothes prices index surged 12.56%, while the food price index rose by 10.15%, month-on-month. The housing and service price indices also increased, but at a lower rate, by 3.64% and 4.16%, respectively. Despite demand pull factors related to the celebration of Idul

[79] *Henny Sender, Money Isn't Everything, Far Eastern Economic Review, February 12,1998.*

Fitri, the sharp increase in inflation in January seemed also to be triggered by the sharp fall of the rupiah against the U.S. dollar in that month.

8. February 1998

At the beginning of February, Asian markets roared into the year of the Tiger with evidence that foreign confidence in the region was returning. "It's all over, the Asian crisis. That seems to be the sentiment this morning," said Callum Henderson, managing analyst at MMS International. Stock and currency markets firmed and volumes soared as longer-term, value-oriented funds flooded back into Asia from Europe. Shorter-term portfolio flows from the United States followed along. Currencies were also stronger, firming or consolidating at higher levels, as confidence seemed to reappear. (See Figure 3.2, 3.3, 3.4, 3.5)

"There are some early signs of confidence coming back or being restored, even though on the fundamentals, nothing has changed," said Ambrose Chang, chief investment officer at Daiwa Capital Management in Hong Kong. A crisis of confidence over Asian economies had been blamed for the region's six-month market pounding, but on February 2, that sense of crisis seemed to ebb a little. The strength was driven by strong liquidity, and concurred with the region's traditional tendency to rally on the first day after the lunar new year. But analysts confirmed evidence to support the stronger tone. Volatility will continue for the coming months, as the painful realities of Asia's economic adjustment unemployment, inflation, and inevitably, social unrest start to hit sentiment negatively once again.

On February 3-5, World Bank President, James Wolfensohn, visited Indonesia to discuss the impact of the economic crisis on Indonesia's low income and poor populations. On February 3, Singapore Prime Minister, Goh

Chok Tong, visited with President Suharto and volunteered to form a multilateral committee of eight countries that would guarantee L/Cs (Letters of Credit) issued by Indonesian banks. Since the monetary crisis began, foreign banks no longer honored L/Cs issued by importers from Indonesia, fearing they could not meet their commitments. Essential imports had temporarily stopped coming into Indonesia due to rejected L/Cs. Goh Chok Tong's proposal was expected to return confidence to L/Cs issued by Indonesian banks.[80]

On February 4, the rupiah led gains, scooting past the 10,000 level to trade at 9,200 in early afternoon. U.S. dollar sales by central bank and hedge funds boosted the unit, which also won support from the Singapore plan to guarantee letters of credit to allow Indonesia to continue to import key goods. Demand for dollars had been somewhat softened by the fact that under Indonesia's temporary debt freeze programs, borrowers were able to roll debt forward and postpone payments, so the bunching of debt and demand for dollars had come off.

On February 6, Indonesia shined, with the stock market shooting up more than four percent. Investors bet that many of the market's indebted companies would be taken over by their foreign creditors. The composite index closed up 4.27%, or 21.94 points higher, at 535.43 on heavy volume. The market got a boost from new government moves to tackle Indonesia's mountain of corporate debt, which stood at $73.962 billion out of a total $137.4 billion in foreign debt. Radius Prawiro, the Indonesian government's chief debt negotiator, said the International Finance Corporation and other banks would provide $42 billion in credit for 42 domestic companies. Prawiro also said the government would quickly move to set up a bankruptcy law in line with the IMF's requirements.

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[80] *BNI Securities, Daily - Corporate News, February 4, 1998.*

The government said it would issue a new regulation soon to increase the minimum paid up capital for banks from Rp50 billion to Rp500 billion. The banks were expected to meet the requirement within one to three years. The banks also had to meet the 12% capital adequacy ratio within the same period. The increased paid up capital was expected to enhance the capital structure of banks and to anticipate the merger of some banks.[81] Later the Central Bank governor, Soedradjad Djiwandono, announced that the minimum paid up capital would be raised to Rp1 trillion by the end of 1998. Only 11 banks currently met this criterion, hence, bank mergers and foreign infusion of capital were expected to hasten in 1998. The minimum paid up capital would be Rp2 trillion by the end of 1999 and Rp3 trillion by the end of 2003. This move was a part of Bank Indonesia's continued effort to strengthen the Indonesian banking sector. Nevertheless, most of the domestic banks would have to work hard to comply with this requirement, since most of them had very little paid up capital. This new regulation was expected to accelerate mergers among banks, and significantly reduce the number of domestic banks by the end of 1998.

On February 10, Southeast Asian currencies skyrocketed against the U.S. dollar in Asian trading amid indications that Indonesia might peg the value of its currency to the dollar. In late Asian trading, the rupiah was propelled to a high of Rp7,450 to the U.S. dollar, up an astonishing 28% from its level of Rp9,500 late Monday, as investors scrambled to buy rupiah with dollars. Rumors that Indonesia might establish a currency board a system whereby the entire supply of local currency is 100%-backed by the U.S. dollar reserves at a fixed exchange rate had circulated for weeks. The market had largely dismissed the notion as unfeasible.

[81] *BNI Securities, Daily - Corporate News, February 9, 1998.*

However, Indonesia's President Suharto said he intended to "fix the currency at a certain rate" to drive off speculators without squandering dollar reserves supporting the rupiah.[82]

"People immediately started accumulating rupiah in the expectation of being able to sell them back later at Rp5,500 to the U.S. dollar" said Daragh Maher, a regional economist at ING Barings in Singapore. The Rp5,500 level was being considered as the peg for the rupiah. Indonesian stocks skid 2.2%, as the main index in Jakarta fell 11.553 to 517.701. Much of the selling, though, was tied to stocks that also traded in overseas markets; the surge in the value of the rupiah made these stocks a better value in foreign markets.

Elsewhere, stocks jumped on the currency's gains. Although the long-term effects of a currency board on the Indonesian economy were in doubt, leading some pundits to predict the scheme's inevitable failure should it be introduced, the rupiah's rally still sent other regional currencies sharply higher. The rupiah jumped more than 30% during one day, as traders got more excited about the prospect of Indonesia adopting a currency board, or some other system of fixing the exchange rate. But despite the move, few in the market seriously believed it was a possibility or that it would work or last. However, People were afraid Indonesia might implement a currency board. That prospect, even if it doesn't last more than a couple of months, means that if you're long in dollars you want to get out. The system creates a stable exchange rate because it ensures that every unit of local currency on issue is backed by the equivalent in, say, U.S. dollars reserves which

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[82] *Darren McDermott and Jay Solomon, Suharto Considers Pegging Rupiah to Dollar, The Wall Street Journal, February 10, 1998.*

analysts said Indonesia certainly does not have at the moment.

Indonesia's central bank governor, Sudradjad Djiwandono, said after a meeting of top economic policy makers that a proposal to adopt a currency board system was being studied, but no decision had yet been taken. The general view among analysts was that with Indonesia's massive economic and debt problems, this was no time to try and fix the currency using any sort of system. Christa Marti, economist at UBS Securities in Singapore, said if the peg was established at Rp5,500, traders and investors would immediately switch to U.S. dollars, at the current rate of about Rp7, 000. In effect, they would be betting that the government wouldn't be able to keep the rupiah at what they saw as an overvalued level (particularly if the currency comes under attack from traders, as seem likely). To stem the flight from rupiah, inter bank rates would have to go much higher. That in turn would make it even more difficult for companies to repay debts and would exacerbate the already critical problem of nonperforming loans at Indonesian banks.[83]

Steven Hanke, a John Hopkins University economist, said a currency board would work because it would strengthen the rupiah to a level where most Indonesian companies are solvent again, increase transparency and limit corruption by removing the central bank's powers and insuring government spending was prudent. In working a paper prepared for the Indonesian government, Mr. Hanke said Indonesia could peg the rupiah at 5,500 to the dollar. "The currency could return to stability, inflation would decline, while interest rates would dramatically collapse," he wrote, "thus triggering a virtuous circle of higher growth, lower

[83] *Salil Tripathi, Hanke Panky?, Far Eastern Economic Review, February 19, 1998.*

corporate defaults, lower unemployment, abating fears of social tensions and, ultimately, stability of the nation."[84]

On February 11, stocks in Indonesia fell sharply, amid fears that the country could be hit by a mounting social backlash against their economic crisis. The Jakarta stock market demonstrated that despite recent signs of recovery, Indonesia's crisis was far from over. Traders rushed to sell on rumors that riots had broken out to protest rising food prices and as the government warned, that unknown parties were seeking to undermine the economy. Stocks fell drastically in the afternoon session, people sold stocks based on rumors, according to one broker. The composite index dove 30.09 points to 487.61, a fall of 5.81%. Even strong performance by the rupiah, boosted by the growing likelihood that the currency board would replace the current exchange rate system, failed to reassure the stock market. Finance Minister, Mar'ie Muhammad, told parliament that the government was drawing up a framework for such a system, and it would be submitted to the legislature in the near future.

On February 12, the composite index shed 45.321 points or 9.29% to end at 442.289 on news of more price riots in a West Java town and fears that the government's move to fix an exchange rate for the rupiah would mean more pain for the economy. Foreigners were very concerned over the currency board system. The beleaguered rupiah remained near the 7,000 per dollar level for most of the day, up from a low of Rp7,800, after the ruling Golkar party named Parliamentary Speaker, Harmoko, and Research and Technology Minister, B.J. Habibie, as vice-presidential candidates in the March indirect election. Habibie, seen as the front-runner, was considered by economic analysts as a financial maverick. On

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[84] *Darren McDermott and Jay Solomon, Suharto Considers Pegging Rupiah to Dollar, The Wall Street Journal, February 10, 1998.*

February 12, the ruling party Golkar nominated B.J. Habibie for the vice-president. Golkar and PPP endorsed B.J. Habibie to be President Suharto's preferred running mate in the presidential elections on March 11. Indonesia's stock market fell 9.8% after that nomination.[85]

On February 13, the IMF and the U.S. officials gave a cool reaction to Indonesia's plans to set up a currency board. U.S. economist Steven Hanke, after meeting with the Indonesian officials, declared that the Indonesian government remains in favor of a currency board. The IMF and major economic powers warned Indonesia not to impose a rigid currency regime now, saying it could shake confidence in Indonesia. The IMF opposed the currency board and threatened to pull the plug on its roughly $40 billion rescue effort.[86] In his most strident comments on the issue, IMF Managing Director, Michel Camdessus, said Indonesia should pursue a series of economic reforms before establishing a currency board to fix the value of the rupiah currency. Policy makers feared that Indonesia's failure to stabilize its economy risked spreading Asia's financial crisis to the world.

Against the advice of the IMF and major lenders, the government said it would quickly establish a currency board to fix the value of the rupiah. A currency board is an inflexible regime with a fixed exchange rate under which a country issues money only when backed by sufficient reserves. Research and Technology Minister, B.J. Habibie, said "President Suharto asked all ministers to find ways to stabilize the rupiah, and we have implemented the IMF

[85] *Sander Thoenes, Indonesia stocks fall on Habibie decision, February 13, 1998.*

[86] *Peter Passell, In Indonesia, Showdown On Risky Bet, The New York Times, February 19, 1998.*

programs, but still the rupiah has not been stable. Then the idea of implementing the Currency Board System was proposed."[87] Camdessus countered that his opposition to the idea had the unanimous backing of the IMF executive board. The United States, which until now had refrained from publicly warning Indonesia, immediately supported his stance. He said a number of preconditions must be satisfied before a currency board is implemented. Backers of the currency board idea said it might be the only alternative for Indonesia to restore confidence in its currency, and thereby help local companies cope with huge foreign currency debts.

U.S. Deputy Treasury Secretary, Lawrence Summers, said Indonesia would be wrong to think that it can solve its economic problems through a currency board without undertaking serious economic reforms. Testifying in congress, U.S. Treasury Secretary, Robert Rubin, and Federal Reserve Chairman, Alan Greenspan, emphasized the rigid discipline necessary to successfully implement a currency board. Mr. Rubin said that Indonesia still needs to think through a number of issues before proceeding. Camdessus warned that introducing the currency board could harm the IMF-led package. On February 14, President Clinton phoned President Suharto and discussed Indonesia's restructuring program by telephone. President Clinton urged Indonesia not to establish a currency Board System. President Suharto reportedly told President Clinton that the IMF-mandated program was not stabilizing the rupiah, and additional actions may be necessary. The plan for currency board would

[87] *Jay Solomon and Kate Linebaugh, IMF Offers Face-Saving Proposal to Suharto, The Wall Street Journal February 19, 1998.*

be dropped only if the U.S. and other rich nations came up with an acceptable alternative.[88]

The IMF package, coupled with doubts about the government's commitment to the program of economic and financial reforms that underpins the rescue deal, had not only failed to stabilize Indonesia's markets, but has led to civil unrest. Resident and police in Indonesia reported a second day of rioting in the West Java town of Jatiwangi, where a small tile factory and cars were burned, and outbreaks of violence in the coastal towns of Pamanukan and Losari. Some protestors burned shops, owned by ethnic Chinese, attacked churches and set cars ablaze during protests against rising prices in three West Java towns. On the news, The composite index tumbled 45.32 to 442.29.[89]

The violence erupted for a second straight day in Jatiwangi, 90 miles (150 km) east of Jakarta, with mobs burning a small tile factory and setting cars on fire. They said riots also broke out in the coastal towns of Pamanukan, 60 miles (100 km) east of Jakarta, and Losari, farther east, over rising prices sparked by the fall in the value of the rupiah currency and by a drought. In Bandung, 90 miles (150 km) southeast of Jakarta, troops had been deployed and a number of shops had closed following rumors that students planned to take to the streets. Violence erupted in Sumatra, Sulawesi and Lombok.[90] Some said the risk of widespread social unrest was real in Indonesia, but some said they didn't feel the kind of tension that could be

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88 *John McBeth, Double or Nothing, Far Eastern Economic Review, February 26, 1998.*

89 *World Stock Markets, Currency peg doubts drive down Jakarta 9%, The Financial Times, February 13, 1998.*

90 *Jay Solomon, IMF Digs In Heels on Indonesian Rupiah Plan, The Wall Street Journal, February 17, 1998.*

expected to surround a major eruption, like in 1964-1965. "It's a combination of factors that are contributing to the problem," said the ethnic Chinese president-director of a bank whose network of rural branches was still performing well, despite the alleged anti-Chinese sentiment. "But I don't think you can call it real social unrest."[91]

On February 16, Indonesia faced growing international resistance to its plan to adopt a currency board system. The rupiah moved to an early low of Rp10,800 to the dollar following persistent dollar sales by U.S. investment banks around the Rp10,500 level. The IMF threatened to withdraw assistance to Indonesia if it adopted a currency board. A senior cabinet minister said the government was seriously studying the currency board proposal and would discuss it with the IMF. Indonesia said it was moving towards a fixed exchange rate system, calling on the IMF to come up with an alternative for strengthening the rupiah currency, if it objected to the plan. The government wanted to strengthen the rupiah to a reasonable level as quickly as possible. The collapse of the rupiah since last July had plunged Indonesia into its worst economic crisis in decades, forcing up prices and unemployment among 200 million people spread across the country's 17,500 islands. The rupiah was trading around Rp9,800 against the dollar. It was around Rp2,400 last July before the collapse, and analysts expected a fixed rate of about Rp5,500.

On February 17, President Suharto appointed Sjahril Sabirin as the new Governor of Bank Indonesia, replacing Sudradjad Djiwandono. The state secretariat released a presidential decree signed February 11 replacing the central bank governor, Soedradjad Djiwandono, with Sjahril Sabirin. The decree said the change in governors was "necessary" and

[91] *John McBeth and Salil Tripathi, Playing With Ire, Far Eastern Economic Review, March 5, 1998.*

that Mr. Soedradjad was "terminated with respect."[92] Sjahril Sabirin served as a Bank Indonesia director from 1987 to 1992 and then worked with the World Bank in Washington before returning to the Indonesian bank in December 1997. The rupiah closed at around Rp9, 400.

On February 20, Indonesia moved to restore fading confidence among Indonesians in their government by guaranteeing a payout on all legal deposits in 16 banks liquidated last year. The government previously had said it would cover up to 20 million rupiah in each account of the 16 banks, which amounted to 1.7 trillion rupiah. Japan announced a series of new loans, totaling 300 billion-yen ($2.36 billion), to support Indonesia's recovery. The United States, Japan and Australia announced a plan to grant export credits to Indonesia to help the country import badly needed commodities and raw materials.

On February 21 to 22, Indonesia suspended its plan to implement a controversial currency-board system that would have pegged the rupiah to the U.S. dollar. The Indonesian monetary official noted that some of the risks involved in the currency board had been taken seriously, and the plan was not going to be implemented. A representative of the IMF in Jakarta welcomed the news, as the removal of an irritating distraction that had been blocking efforts to move forward with serious banking-sector reform, and plans for dealing with the nation's $74 billion in the private sector debt. U.S. Treasury Secretary, Robert Rubin, expressed satisfaction with Indonesia's reported decision. He said it would be challenging for Indonesia to stick to the conditions of the IMF's reform program, but that it would be necessary if foreign investors were to regain

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[92] *Richard Borsuk and Jay Solomon, Indonesia Dismisses Central-Bank Governor, The Wall Street Journal, February 18, 1998.*

confidence in the nation. Leaders of the world's seven richest nations pledged at the G-7 meeting to help Indonesia deal with shortages in trade finance and basic necessities particularly medicine and food. Before a G-7 meeting in London, Indonesia sent a letter to the G-7 members, asking for help in stabilizing the rupiah and in handling the country's foreign debt. The Indonesian Finance Minister stated that Indonesia is still committed to the IMF reform package; he hoped the G-7 nations had a way to stabilize the rupiah, which was not disruptive to the IMF reform package.

On February 26, representatives of foreign bankers and their Indonesian corporate borrowers offered little evidence of progress following their first meeting. Officials on both sides expressed optimism about the ability of the group to deal with Indonesia's $73 billion in private offshore borrowings. The main objectives of the initial meeting, according to Radius Prawiro, President Suharto's special adviser on private external debt, were to stress to foreign bankers that those Indonesian companies that can pay will do so a message that Mr. Prawiro had repeated since he announced in January a pause on debt repayments. The meeting also produced yet another agreement to compile a complete inventory of Indonesia's debt, something international bankers had been demanding for weeks.

9. March 1998

The Indonesian economy was on the brink of hyperinflation, with prices soaring at rates not seen since the mid-1960s when President Suharto first came to power, according to figures released by the government on March 2. Month-to-month inflation jumped to 12.76% in February after a 6.88% rise in January; the year-to-year rate, as calculated by Reuters, was around 31.74%. February inflation was the highest monthly inflation in the entire new order era. As a rule of thumb, hyperinflation was defined as price increases between 40 and 50%, analysts said. According to the official figures, food price rose 16.07% in February, housing 10.03%, textiles 15.62%, and services 9.31%.

But food prices were rising at a much faster rate than official figures showed, and had been the main cause of civil unrest. Anecdotal evidence suggested that in recent weeks, on a month-to-month basis, cooking oil had risen in price by around 130%, rice 34%, flour 33%, eggs 88%, and chicken 34%. Bank Indonesia director, Miranda Goeltom, announced that current foreign reserves stood at US$16.3 billion at the end of February, losing around 14% from the end of January.[93]

President Suharto's March 1st speech in front of the country's People's Consultative Assembly (MPR) boosted positive sentiment in the stock market after little good news over the previous few weeks. The speech, according to some local market players, was perceived as a clear direction of how the government would deal with current economic turmoil: limited active trading despite growing support for regional markets and a strengthening rupiah against U.S. dollar. Some investors commented that the speech discontenting corruption and bureaucratic issues surrounding recent political situations in Indonesia.[94]

On March 2, Indonesian stocks rallied, aided by the regional gains and positive responses to the speech by President Suharto to the People's Consultative Assembly (MPR). President Suharto pledged to follow the IMF reform, and also said he was still considering implementing the currency board idea eventually. He called for an "IMF-Plus"

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[93] *BNI Securities, Daily-Corporate News, March 3, 1998.*

[94] *BNI Securities, Daily-Corporate News, March 3, 1998.*

program.[95] In late trading, the main stock index was 2.52% or 12.18 points higher at 494.56. They continued to go up by 4.42% or 21.96 points to 518.67 on the next day. On March 4, the U.S. and Indonesia appear headed for disagreement over the Indonesian government plan to implement a currency board. The U.S. Envoy to Indonesia, Walter Mondale, told reporters after meeting with President Suharto that the U.S. felt Indonesia must deal with the underlying problems and not look to any quick fixes, referring to the currency board. He also said it is very much in doubt whether Indonesia would comply with IMF requirements. Speaking at a conference in Dallas, Mr. Mondale said President Suharto and his aides "were very open and very candid. I was able to make our case. But what their decision will be I do not know."[96]

On March 5, President Suharto reaffirmed his commitment to IMF reforms, but currency traders and a growing parliamentary opposition indicated their dissatisfaction with the lack of progress on pulling Indonesia out of its current economic crisis. The rupiah fell to the 10,000 level against the dollar for the first time since mid-February, sliding to 9,975/10.325 after trading at 9,500/9,700. Investors worried whether the IMF would go on with the next US$3.0 billion in assistance scheduled for approval on March 15. The British Junior Foreign Minister, Derek Fatchett, told reporters after meetings with President Suharto and Finance Minister, Mar'ie Muhammad, that the government was committed to the program. Economic analysts said the foreign exchange market was reacting to confused signals over the fate of the currency board and the

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[95] *The Economist, The doctors at the door, March 7, 1998.*

[96] *Bob Davis, IMF Signals Assent To Jakarta Currency Board, The Wall Street Journal, March 11, 1998.*

possibility of a delay in the next $3 billion disbursement of IMF assistance to Indonesia. Senior banking sources have said that an IMF review of progress in reforms, due to be completed by March 15, was being delayed by the current political preoccupation with the MPR session. The government had banned mass gatherings and demonstrations during the MPR session, and so far the country had been generally quiet following riots in a number of towns by people angered by rising prices. The most recent demonstrations had been largely confined to university campuses, with students condemning price increases and calling for political and economic reforms.[97]

On March 6, financially battered Indonesia said that it would subsidize imports of food and other essentials to keep prices under control, but warned that any delay by the IMF in disbursing funds from a bailout package would hurt regional currencies. Financial Minister, Mar'ie Muhammad, said Indonesia is confident the IMF will disburse the second $3 billion installment of the fund's $10 billion share of the rupiah bailout. He said any delay would affect the return of investor confidence in Indonesia and "have a negative impact on efforts to strengthen and to stabilize currencies in Southeast Asia. Senior banking sources said the IMF review had been delayed two to three weeks by Indonesia's preoccupation with politics, as it prepared to re-elect President Suharto for a seventh five-year term and the need to re-assess some economic assumptions.

On March 8, President Suharto was quoted as saying the IMF's economic reform package is actually not in agreement with the constitution because it supports a "liberal" rather than a `family-oriented' (kekeluargaan) type of economic

[97] *The Economist, Suharto's Family Value, March 14, 1998.*

system. Meanwhile, the rupiah has plunged again to the Rp11,500/US$1 level.[98]

On March 10, Indonesia re-elected President Suharto for a seventh five-year term. At his inauguration ceremony on March 11, President Suharto called on Indonesians to pull together in this time of hardship and told the nation he was willing to heed loud and blunt criticism during his seventh term. There was little change in stocks after the election result were released, but they declined in afternoon trading, leaving the key index 1.08% lower, or 5.34 points, at 490.48. The rupiah also changed little and was trading around Rp10,500 to the dollar in late trade.

The deputy head of the IMF said the fund was ready to be flexible on its reform program with Indonesia. The IMF's First Deputy Managing Director, Stanley Fischer, said the IMF was paying special attention to the humanitarian aspects of the debate about whether to release another installment of its $10 billion loan to Indonesia.

> We would want to allow imports of food at cheap prices and other things that would take care of social problems," Fischer said in an appearance on CNN's `Moneyline with Lou Dobbs on March 10.' He said the IMF recognizes that it must adjust its programs as reality changes. Fischer said that includes careful monitoring of Indonesia's economy. "We would have to renegotiate the monetary and fiscal program because Indonesia's economy has changed. Also, the exchange rate is way off from where we expected.

Fischer said that the IMF always looks at changing circumstances in deciding whether its programs need to be modified, and would probably do so in Indonesia. But Mr. Fischer gave no indication that the fund was prepared to

[98] *BNI Securities, Daily-Corporate News, March 9, 1998.*

change its basic approach.[99] IMF officials have said they would not be in a position to decide whether to make additional money available to Indonesia before April because a government was not yet in place and a string of structural measures needed to be introduced. Bank Indonesia announced new banking rules such as setting the maximum interest rate for third party deposit banks at 25% above Certificate of Bank Indonesia, allowing banks to have prize draws, with the maximum value of 1% above interest expense, etc.

On March 13, Indonesian shares were higher in quiet trading, ahead of the impending announcement of a new cabinet. Also topping Indonesia's upcoming agenda was a gathering of top regional and international political and financial leaders, all of whom were bent on getting President Suharto to adhere to the terms of the IMF accord. The Jakarta Stock Exchange Index was up 1.72%, or 8.55 points, at 506.73. The line-up heading for Jakarta included Japanese Prime Minister, Ryutaro Hashimoto, and senior financial ministry official, Eisuke Sakakibara, a senior IMF team and U. S. Treasury Under-secretary of International Affairs, David Lipton. The possibility Indonesia would introduce a currency board remained the biggest guessing game in international financial circles. In Washington, IMF Managing Director, Michael Camdessus, said the IMF was still opposed to the idea of a currency board because of Indonesia's low level of reserves, its troubled banking system and large corporate debt.

By March 15, President Suharto had appointed a new cabinet. In the reshuffle, President Suharto gave the new vice-president, B.J. Habibie, unprecedented influence in foreign affairs. He was put in charge of relations with multilateral organizations, such as the Association of South

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[99] *Seth Mydans, At Pivotal Time, Suharto Gets a 7th Term, The Wall Street Journal, March 11, 1998.*

East Asian Nations and Asia Pacific Economic Co-operation. Unlike the previous vice-president, Habibie would be responsible for "management of national interests in the era of globalization"- code for dealing with the current economic crisis, and restructuring industry to improve links between large business groups and smaller companies. Another of the vice-president's many jobs will be to "maintain national unity and integrity." This was described by one official as a very wide function crossing cultural, political and economic lines, and one that provided an opportunity for a far-reaching process of decentralization and reformation.[100]

Japanese Prime Minister, Ryutaro Hashimoto, urged Indonesian President to take "courageous decisions" to reform his country's crisis-hit economy. Mr. Hashimoto emerged from more than two hours of candid talks with the Indonesian President, expressing deep concern about the economic difficulties facing the country and calling on President Suharto to stand by his agreements, including his deal with the IMF.[101] Officials from the IMF arrived in Jakarta over the weekend for continuing talks on implementing the reform program, (which was agreed to in exchange for a $40 billion financial rescue package.) But the drastic shake-up of the cabinet was likely undermining the IMF's efforts to implement the reform package established in January.

The fund needed to decide whether to release a second $3 billion installment and open the way for further help from the World Bank, Asian Development Bank and donor

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[100] *John McBeth, Suharto's Way, Far Eastern Economic Review, March 26, 1998.*

[101] *Sander Thoenes, Suharto's cabinet choices ignores pleas for reform, The Financial Times, March 16, 1998.*

nations. Early this month, the IMF suspended the initial US$3 billion disbursement of a US$43 billion bailout package to Indonesia, citing dissatisfaction with the pace of the economic reform to which Indonesia had agreed as a IMF-led bailout. Indonesia responded to the suspension with a flush of nationalistic statements, implying that Indonesia was ready to suffer the consequences of a possible IMF pullout rather than accede to the IMF's economic-liberalization agenda.

March 17, Coordinating Minister for Economy, Finance and Industry, Ginandjar Kartasasmita, speaking to reporters after the new government's first cabinet meeting, said Indonesia wouldn't implement a currency board "for now" because the country lacked adequate foreign reserves to make a dollar peg stick. At the same time, an IMF official in Jakarta conceded the IMF would probably have to relax certain fiscal and other requirement for Indonesia, in light of the country's social needs arising from the battered rupiah and a punishing drought. The IMF probably will be more flexible in allowing Indonesia to allocate a larger portion of its budget than planned to subsidize food and medicine, this official said.[102]

By March 21, The IMF and the Indonesian government made "considerable progress" toward a new deal to counter the country's grave economic crisis, according to the IMF's top official for Asia. Hubert Neiss had came to Indonesia amid fears that Indonesia was backsliding on commitments to implement tough and sweeping reforms under the $43 billion IMF-sponsored bailout. Neiss met Indonesian cabinet ministers to discuss revising its terms. The head of Indonesia's national logistic body, which controls the

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[102] *Jay Salomon and Richard Borsuk, Indonesia,IMF appear to move closer to accord, The Wall Street Journal, March 18, 1998.*

marketing of basic food items, said the IMF team had agreed to an Indonesian request to maintain state subsidies for nine essential food categories, as well as basic medicines. Finance Minister, Fuad Bawazier, said he hoped a new agreement could be struck with the IMF by the next week.

On March 26, the Indonesian government said it was closed to a comprehensive package of measures to lift the country out of its worst economic crisis in three decades. Finance Minister, Fuad Bawazier, told reporters that the package of measures was being finalized in talks with the International Monetary Fund. "Let us wait to conclude the talks. It's a very comprehensive package, very wide, touching on macro and micro economic issues, we will announce it once we reach an agreement," said Bawazier.

The World Bank said it was coordinating humanitarian relief for Indonesia and hoped to supply imports of food and other essentials worth $1.5 billion in 1998-99 (April-March). The successful conclusion of the talks with the IMF, which included a review of reforms Indonesia to which had agreed in exchange for a $40 billion bailout, would bring much-needed funds into the country. The IMF would release the second $3.0 billion from the bailout package and some $2.5 billion in funds from the World Bank and the Asian Development Bank would also become available. Japanese banking sources in Jakarta said Tokyo planed to negotiate and sign a $1.0 billion trade financing loan in yen equivalent, once the IMF review was completed.

Diplomatic and political analysts said relations between Indonesia and the IMF had warmed appreciably in recent days after a period of strain. Indonesia appeared to be back on an orthodox IMF-approved track of reform, while Indonesia also won some concessions from the IMF, including approval to continue subsidies on essential commodities. The central bank, Bank Indonesia, raised key interest rates an average of 12.7% in a move that quickly won IMF praise.

The government also scrapped a proposed 5% tax on foreign currency purchases after consultations with the IMF. The new minister for state-owned companies, Tanri Abeng, said the government was actively working to deal with some $74 billion in private foreign debt, which has led to a massive loss of investor confidence. "Because the IMF has agreed that the government takes the initiative in solving private debt, we are going to make it compulsory for corporations to report their debts," he said. But he also stressed there was no government bailout involved and the government was taking no credit risk.

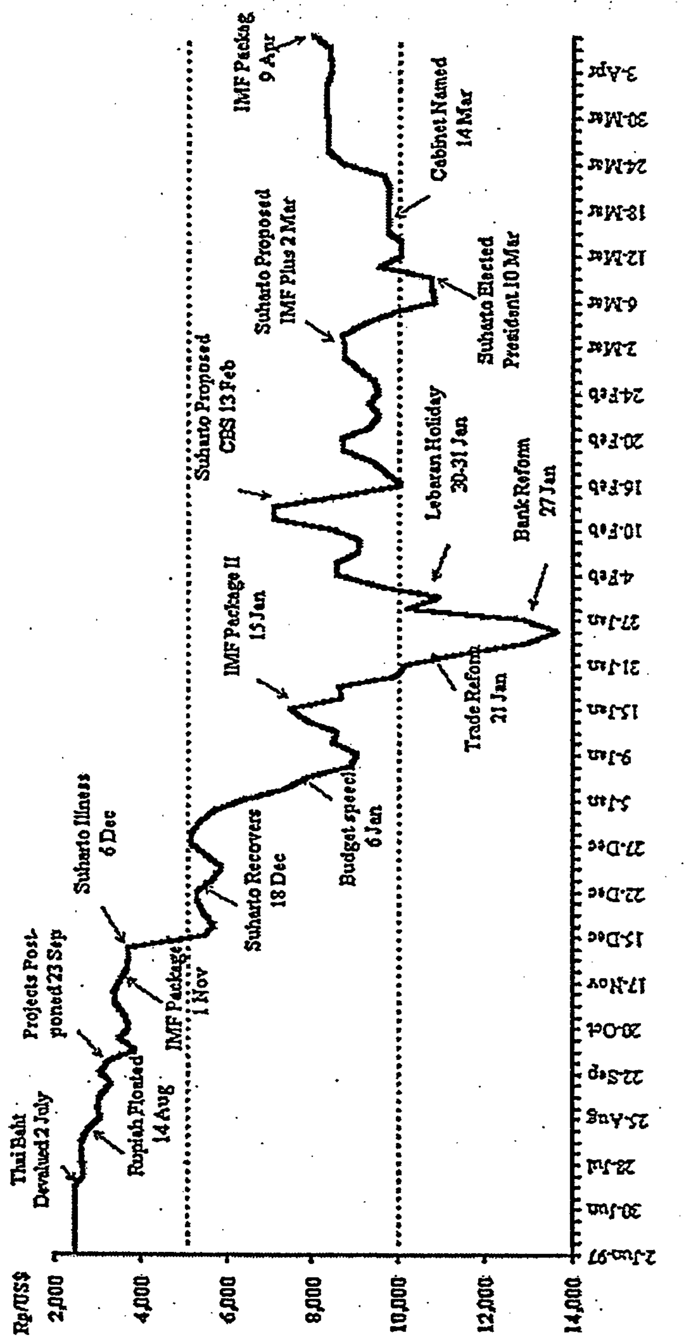
> "What we want to achieve first is to reduce pressure on the rupiah to allow the currency to recover, secondly, we want to give our private companies the chance to resume their business operations, so that economic life can return. Everything is at standstill now," Abeng said, adding that the crucial issue is how to reschedule the debt.

The collapse of the rupiah from around Rp2,400 to the dollar last July sparked sporadic protest over rising prices and unemployment. It threw most companies into technical bankruptcy and brought trade to a virtual standstill. A steering committee of banks that have lent money to Indonesian companies met in Singapore, but no details were immediately available. Sources said the talks "were more substantial" than they were previously. An initial total of 54 domestic banks will be addressed by an agency the Indonesian government established to rehabilitate insolvent banks.

The bankers in Jakarta, knowledgeable about developments at what's called the Indonesian Bank Restructuring Agency (IBRA), said that specific plans for dealing with the banks would be unveiled after Indonesia and the IMF revised the terms of an IMF rescue program for the economy. Fifty-four banks already placed under IBRA included thirty-nine privately owned commercial banks, four state banks, and eleven state-run provincial development banks. Some bankers speculated that after the new Indonesia-IMF deal was announced, many of the banks currently under IBRA would be effectively forced to merge, sharply reducing the total number of Indonesian banks from about 200 at present. The bankers also believed that dozens of other banks not yet under IBRA would soon be shifted to the agency's responsibility.

At the end of the month, Indonesia and the IMF had been working for about two weeks to solve the nation's private debt problem, a key step in lifting the nation out of its worst economic crisis in decades. Concerned about the debt formula, Hurbert Neiss, the leader of the IMF, said it was based on Mexico's Fiarco program. "The IMF, the Indonesian government, the World Bank and other observers think the Mexican model has merit, it has some merit because it provides some attractiveness to the creditors, and at the same time it limits the financial involvement of the government and that is very important." Indonesia said it would prepare a draft bankruptcy law by next April in order to revive investor confidence in the economy.

Singapore Prime Minister, Goh Chok Tong, announced a trade financing scheme aimed at helping hundreds of Indonesian firms buy vital imports. The scheme would be financed by at least $2 billion originally pledged by Singapore for the IMF's $43 billion rescue package for Indonesia. Indonesia approached the IMF after the rupiah currency plunged last year. The currency has fallen some 70% against the dollar since July 1997, causing 30-year highs in inflation, doubling unemployment to about nine million people, bringing trade to a standstill and instigating riots and social unrest to protest higher food prices.



Sources: BI (middle rate), TCG
TCG - 980402 - ICP

Figure 3.2 Rupiah vs. U.S. dollar Exchange Rate

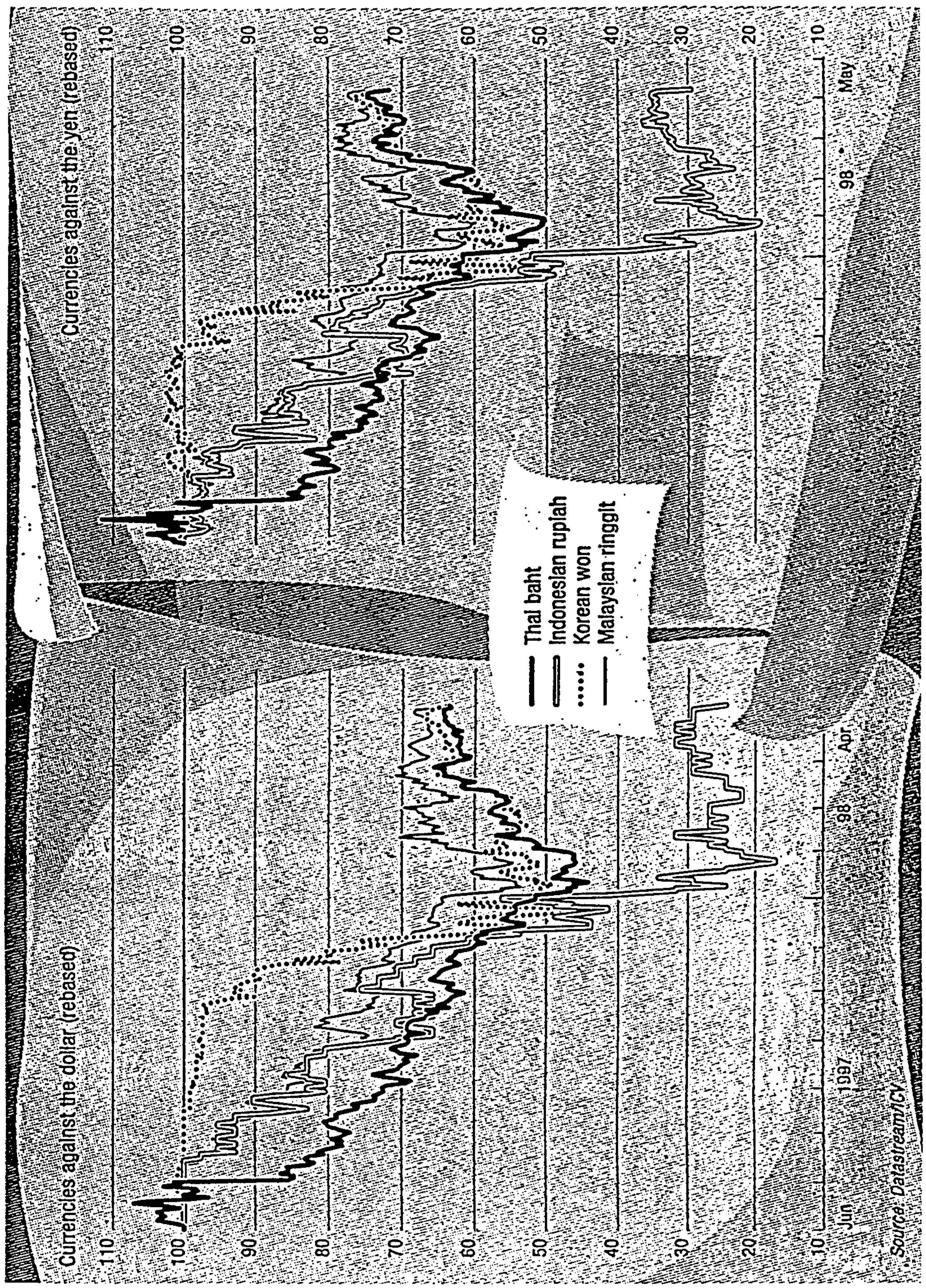
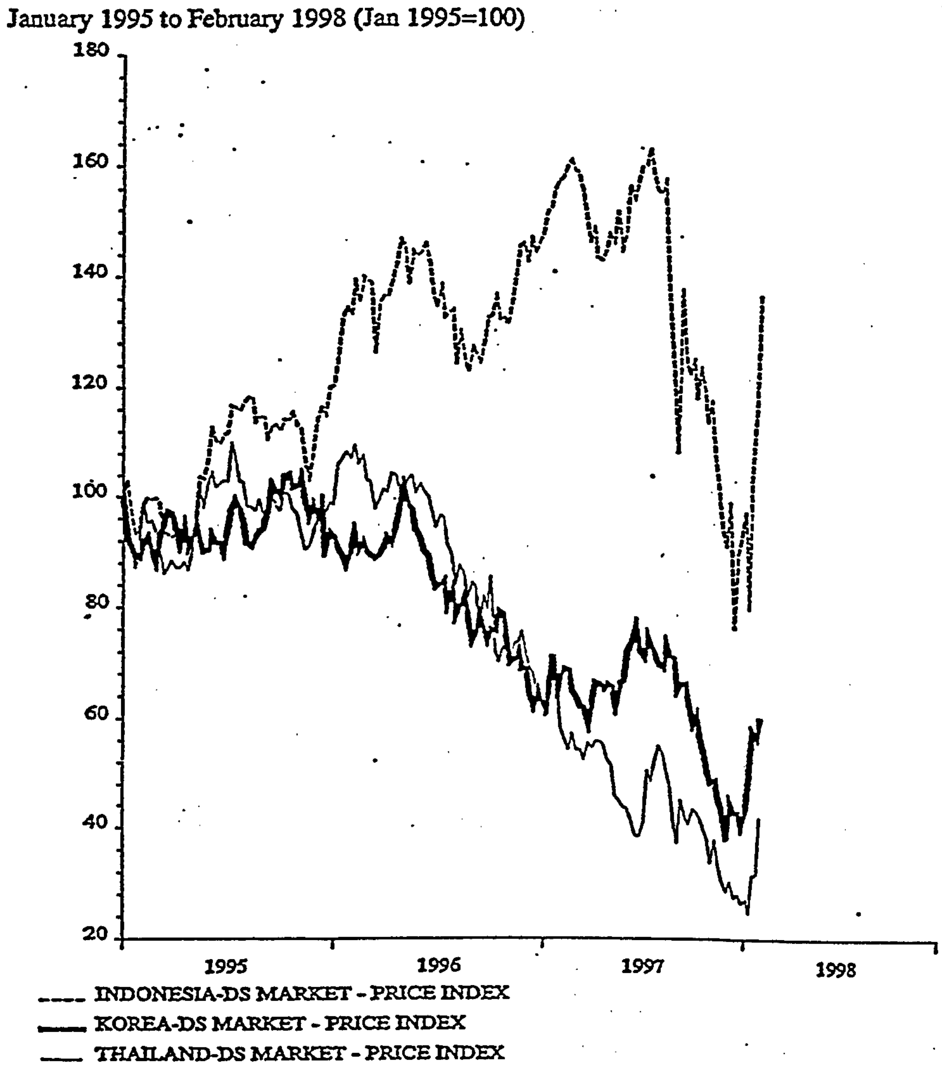


Figure 3.3 Currencies against the dollar and the yen



Source: Datastream

Figure 3.4. Stock Market Indices

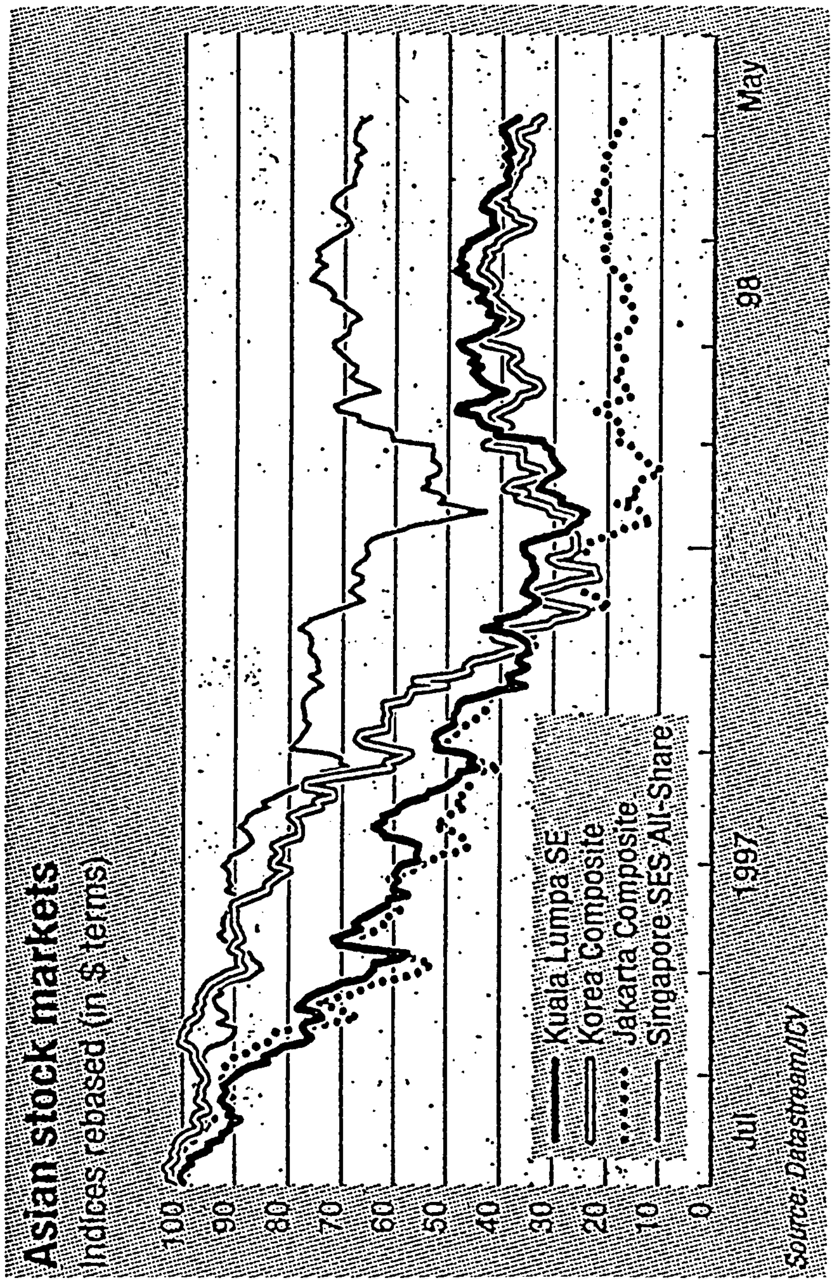


Figure 3.5. Asian Stock Markets

Table 3.10. The middle exchange rate of the U.S. dollar at Bank Indonesia, 1992 - 198

End of Year/ Month	Exchange rate in Rupiah	Increase (%)
1992	2,062	- per year
1993	2,110	2.3
1994	2,200	4.3
1995	2,308	4.9
1996	2,383	3.7
1997	4,650	95.1
July	2,599	6.1 per month
August	3,035	16.4
September	3,275	7.9
October	3,670	12.1
November	3,648	-0.6
December	4,650	27.5
1998 January	10,375	123.1
February	8,750	-15.7
March	8,000	-8.6

Source: Bank Indonesia

Table 3.11. Composite Index at the Stock Market

End of period	JSX	(point) SSX
1996		
March	585.70	400.09
June	594.25	410.13
September	573.30	512.19
December	637.43	568.58
1997		
January	691.11	623.78
February	705.37	636.97
March	662.23	594.00
April	652.05	583.10
May	696.02	623.26
June	724.55	642.99
July	721.27	641.28
August	493.96	438.51
September	546.68	488.79
October	500.41	448.29
November	401.70	357.41
December	401.71	351.95
1998		
January	485.94	n.a
February *)	472.21	n.a

*) As per 17 February
Source: Bank Indonesia

Table 3.12. Volume and Value of Share Trading in the Stock Market

(point)

Year/month	Transaction Volume (million)	Value (Rp billion)
1992	1,745.0	8,088.3
1993	4,110.9	20,234.8
1994	5,785.0	27,268.5
1995	12,361.6	37,620.7
1996	31,085.1	79,830.1
Quarter I	5,269.6	15,708.4
Quarter II	6,078.0	18,134.3
Quarter III	8,186.2	18,809.1
Quarter IV	11,551.3	27,178.3
1997	81,573.2	146,941.5
January	5,240.6	10,596.2
February	3,678.2	9,124.2
March	4,063.1	10,674.3
April	4,214.3	8,945.6
May	5,349.4	10,731.2
June	6,613.5	12,926.1
July	7,589.9	15,415.8
August	7,940.1	28,833.7
September	9,278.2	11,668.2
October	9,278.2	11,058.9
November	7,149.1	7,731.0
December	11,178.6	9,236.3

Source: Bank Indonesia

IV. THE CAUSES OF FINANCIAL CRISIS

The causes of the financial crisis in Indonesia can be explained by several factors. It started from the Thailand Crisis and spread through the Contagion/Spillover Effect. It then continued through structural weaknesses, debt, a crisis of confidence, globalization and integration of the financial/capital market, investor and panic stricken lenders, speculators, socio political effects and foreign exchange rate adjustments.

A. START FROM THAILAND

The problems began in Thailand, where there were numerous signs of impending crises. Macroeconomic indicators pointed to substantial imbalances; the real exchange rate had appreciated substantially, export growth had slowed markedly, the current account deficit was consistently large and was increasingly financed by short-term inflows, and external debt was rising quickly. The external debt statistics released by OECD showed that since 1990, Thailand's debt was increasing significantly. In 1992, Thailand ranked seventh of the ten countries whose debt had increased the most. In 1993, Thailand was ranked second and became the country with the largest debt increase in 1994 and 1995. The bulk of the increase was in the most volatile type of debt, short-term bank loans, although long-term ODA loans, bank lending and trade credits also expanded.[103]

These problems, in turn, exposed other weaknesses in the Thai economy, including substantial unhedged foreign

[103] *External Debt Statistics, 1996 edition, OECD*

borrowing by the private sector, an inflated property market, and a weak and over-exposed banking system. Markets also warned of insustainability in Thailand's policies, as seen in lower equity prices and mounting exchange rate pressure.[104] The crisis erupted in Thailand in the summer of 1997. Starting in 1996, a confluence of domestic and external shocks revealed weaknesses in the Thai economy that until then had been masked by the rapid pace of economic growth and the weakness of the US dollar to which the Thai currency, the baht, was pegged.

To an extent, Thailand's difficulties resulted from its earlier economic success. Strong growth, averaging almost 10% per year from 1987-1995, and generally prudent macroeconomic management, as seen in continuous public sector fiscal surpluses over the same period, had attracted large capital inflows, much of them short-term, and many of them attracted by the establishment of the Bangkok International Banking Facility in 1993. While these inflows had permitted faster growth, they had also allowed domestic banks to expand lending rapidly, fueling imprudent investments and unrealistic increases in asset prices.

Past success may also have contributed to a sense of denial among the Thai authorities about the severity of Thailand's problems and the need for policy action. Neither the IMF in its continuous dialogue with the Thais during the eighteen months prior to the floating of the bath last July 2, 1997, nor increasing exchange market pressure, could overcome. Finally, in the absence of convincing policy

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[104] Michel Camdessus, The Asian Crisis and The International Response, Address at The Institute of Advanced Business Studies (IESE) of the University of Navara, Spain, November 1997, IMF.

action, and after a desperate defense of the currency by the central bank, the crisis broke.[105]

B. CONTAGION OR SPILLOVER EFFECT

Once the crisis hit Thailand, the contagion to other economies in the region appeared relentless. Some of the contagion reflected rational market behavior. The depreciation of the bath could be expected to erode the competitiveness of Thailand's trade competitors, and this put downward pressure on their currencies. The strongest pressure emerged initially in the Philippines, where the authorities had also been maintaining a de facto exchange rate peg to the U.S. dollar. After seeking briefly to defend the peg through interest rate hikes and intervention, the authorities allowed the peso to float on July 11, 1997. They subsequently imposed restrictions on the sale of nondeliverable forward contracts to nonresidents in an attempt to limit speculation against the peso.

Spillover/contagion effect spread quickly to Malaysia, where the authorities opted to allow the ringgit to depreciate rather than raise interest rates, and also to Indonesia, where on July 21, 1997, the rupiah fell sharply within the official intervention band. The intervention band for the Indonesian rupiah was widened from 8 to 12 percent in July 1997 in a preemptive move designed to deter speculation. The rupiah had depreciated by 8% by July 21, 1997; as it fell toward the bottom of the band, some speculative pressures built up to test the floor. In response, Bank Indonesia raised interest rates from 12% to

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[105] Stanley Fischer, The Asian Crisis: A View from the IMF, Addressee at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, D.C., January 22, 1998, IMF

13% on July 23, 1997, and reportedly intervened heavily in support of the currency.[106] Subsequent measures to tighten liquidity conditions in Indonesia failed to stem the growing exchange market pressures, and the authorities allowed the rupiah to float on August 14, 1997.[107]

After their experience in the Thailand Market, investors began to take a closer look at the problems in other neighboring countries (Indonesia), and the market saw that some of the problem were the same as in Thailand, particularly in the financial sector. Added to this, the debt service costs of the domestic private sector increased as currencies continued to slide. Fearful about how far this process might go, domestic residents rushed to hedge their internal liabilities, thereby intensifying exchange rate pressures.[108]

The situation worsened markedly over the next two months, reflecting concerns about the effects of currency depreciation and higher domestic interest rates on highly leveraged corporate and financial sector balance sheets and the commitment of the authorities to implement policies needed to restore rate stability. The actual or threatened imposition of controls on capital outflows during the crisis may also have served to further undermine investor confidence.

As the Southeast Asian crisis deepened, spillover/contagion effects began to spread to other countries in Asia, mainly reflecting concerns about the adverse effects on growth and export competitiveness of

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[106] *IMF Staff Team, International Capital Markets, IMF, Washington, DC, 1997.*

[107] *World Economic Outlook, Interim Assessment, IMF, December 1997*

[108] *Stanley Fischer, The IMF and the Asian Crisis, March 20, 1998.*

developments in the ASEAN-4 countries, and also concerns about the soundness of financial systems. The Singapore dollar and New Taiwan dollar weakened moderately in July, and the Hong Kong dollar came under temporary attack in early August. Equity prices in Hong Kong SAR and the Taiwan province of China peaked in August 1997 before turning down, as interest rates were raised to counter exchange rates pressures, and equity prices in China also weakened sharply.

The crisis spread quickly to other countries in Asia, including South Korea. By the second half of October, the unrest became global, and markets in North America, Latin America, Europe, the Baltic States, and Russia all joined in. This is one of the first instances when a crisis in an emerging market has had world-wide financial implications on a significant scale.[109]

C. STRUCTURAL WEAKNESSES, DEBT, AND CRISIS OF CONFIDENCE

In his address at the Midwinter Conference of the Bankers'Association for Foreign Trade in January 1998, Mr. Stanley Fischer, First Deputy Managing Director of the IMF, explained the origins of the crisis in Asia.

> The key domestic factors that led to the present difficulties appear to have been: first, the failure to dampen overheating pressures that had become increasingly evident in Thailand and many other countries in the region (including Indonesia) and were manifested in large external deficits and property and stock market bubbles; second, the maintenance of pegged exchange rate regimes for too long, which encouraged external borrowing and led to excessive exposure to foreign exchange risk in both the financial and corporate sectors; and third, lax prudential rules and financial oversight, which led to a sharp deterioration in the quality of banks' loan

[109] *Shigemitsu Sugisaki, The Global Financial System: Status Report, IMF, November 18, 1997*

> portfolios. As the crisis unfolded, political uncertainties and doubts about the authorities' commitment and ability to implement the necessary adjustment and reforms exacerbated pressures on currencies and stock markets. Reluctance to tighten monetary conditions and to close insolvent financial institutions has clearly added to the turbulence in financial markets.[110]

Indonesia, despite strong economic performance over the past several decades, which has ranked among the best in the developing world, also has a number of underlying **structural weaknesses** which made Indonesia vulnerable to adverse external developments. According to the IMF in press release No.97/50, "Long-standing rigidities in the form of domestic trade regulations, and some import monopolies, impeded economic efficiency and competitiveness." At the same time, less transparency in decisions affecting the business environment and data deficiencies increased uncertainty and adversely affected investor confidence. In addition, large capital inflows, intermediated through a weak banking system, exposed Indonesia to a shift in financial market sentiment. Thus, Indonesia's banking sector was not prepared to withstand the financial turmoil that swept Southeast Asia starting in July 1997.

Similarly, the corporate sector was vulnerable to adverse external developments. Prompted by large interest rate differentials between domestic and foreign rates, private companies had **increasingly borrowed abroad** to finance domestic operations, which in the context of a relatively stable exchange rate were largely unhedged. With the abrupt shift in market sentiment that had occurred since the middle of July 1997, Indonesia had to contend with a

[110] *Stanley Fischer, The Asian Crisis: A View from the IMF, Address at the Midwinter Conference of the Bankers'Association for Foreign Trade, Washington, D.C., January 22,1998.*

major **crisis of confidence**. The rupiah depreciation and the fall in equity prices had been among the largest in the area. The downward pressure on the rupiah persisted, despite policy measures that were timely and broadly appropriate, including the floating of the exchange rate, followed by increases in interest rates and fiscal retrenchment.[111]

The Indonesia Memorandum of Economic and Financial Policies article mentioned that despite the strong macroeconomic performance, **a number of underlying weaknesses** had made the country vulnerable to adverse external shocks. Structural rigidities arising from regulations in domestic trade and import monopolies have impeded economic efficiency and competitiveness. At the same time, the relative stability of the rupiah during most of the 1990s, together with high rates of return on domestic investment, both encouraged and facilitated high levels of overseas borrowing, a significant portion of which has been **private short-term debt** that has been unhedged. By the end of December 1997, **Indonesia's external debt** stood at $140 billion (about two-thirds of GDP), of which $20 billion was short-term, while its debt service had remained close to one-third of exports of goods and services. The rapid expansion of the financial system since the late 1980s also left a number of banks with significant amounts of nonperforming loans, straining their liquidity, and, in a number of cases, undermining their financial viability.

The banking system in Indonesia also created the problem. Since deregulation began in 1988, banks more than doubled in number to reach a total of more than 240, but without proper supervision. Companies over borrowed from

111 *IMF, IMF Approves Stand-By Credit for Indonesia, Press Release No. 97/50, November 5, 1997*

local banks. In addition, the Indonesian private sector borrowed heavily from foreign banks without hedging the foreign exchange risk in case the rupiah fell sharply, as happened after Thailand was forced by a shortage of foreign exchange in July 1997 to let the bath float.

Financial governance in the public and private sectors in Indonesia was weak; the influence of business on political connections was excessive. With the fall of the rupiah, firms were unable to repay their foreign debts. Such structural problems take time to resolve, and involve high social costs.[112] As Shigemitsu Sugisaki addressed the 1998 Harvard Asia Business Conference on January 30, 1998,"Structural factors were at the heart of the economic problems. First and foremost, the crisis was a financial sector crisis.

There were several weaknesses:

- The financial sectors in Indonesia, Korea, and Thailand lack proper standards and supervision. For instance, financial institutions had been allowed to borrow from abroad because of inadequate controls on their foreign exchange exposure.

- The sizeable capital inflows had given rise to investment in equity and property and the risks associated with price bubbles.

- The authorities had, in some instances, come to the rescue of insolvent financial institutions and prevented them from being liquidated.

Other structural problems included:

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[112] *Paul M. Dickie, For Asia, Confidence Means Structural Reform, International Herald Tribune, February 17, 1998*

- **Trade restrictions**, such as the maintenance of trade monopolies, quantitative restrictions on trade, and other trades barriers.

- **Capital controls**, including restrictions on foreigners' access to the equity and corporate bond markets; restrictions on foreign borrowing by corporations (thus, foreign banks could not evaluate the underlying commercial risk associated with their lending).

- **Close links between the government, banks, and corporations,** created a problem in all three countries (Indonesia, Korea, and Thailand), as economic decisions and financial relations lacked transparency and accountability, and inappropriate investment decisions undermined the health of the financial sector.

- **Governance issues** concerned the implementation of policies, including lack of transparency. Financial institutions and corporations also suffered from poor governance.[113]

D. GLOBALIZATION AND INTEGRATION FINANCIAL/CAPITAL MARKET.

During the last decade, the integration of financial markets had progressed significantly and had helped promote a better distribution of world savings. From the 1970's

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[113] *Shigemitsu Sugisaki, Economic Crises in Asia, Addressed at the 1998 Harvard Asia Business Conference, Harvard Business School, January 30, 1998, IMF*

through the early 1990s, advanced countries (industrial countries and newly industrial countries in Asia, Taiwan, Hong Kong, South Korea and Singapore) went through a dismantled exchange and capital controls. This occurred simultaneously with the deregulation of domestic financial markets and financial innovations. The improvement of communications significantly decreased transaction costs. International capital movements increased and initially concentrated in offshore markets and banks; then from the mid-1980s in reformed domestic markets and security markets. Cross-border transactions in bonds and equities in the major advanced countries, which were less than 10% of GDP in 1980, had generally risen to over 100% of GDP in 1995. The daily turnover in the foreign exchange market expanded from about $200 billion in the mid-1980s to around $1.2 trillion in 1995, equivalent to 85% of all countries' foreign exchange reserves.[114]

In developing countries, private capital flows picked up substantially following the lifting of controls on cross-border flows, especially on inflows. This followed progress in convertibility of current account transactions. Reflecting the liberalization of the economies and in the high growth performance and relative macroeconomic stability, capital flows have expanded quickly. In the period from 1990 to 1996, for example, net private capital inflows to developing countries nearly doubled, from about $131.3 billion in 1991 to $207.4 billion in 1996, benefiting particularly equity and portfolio investments in emerging market economies. Asia's share of capital flows rose particularly fast, from one third of total private flows in 1990 to as much as half of those flows in 1996.[115]

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[114] *IMF,World Economic Outlook, May 1997.*

[115] *IMF, World Economic Outlook, October 1997.*

In the 1980's and 1990's, as globalization and changes in policy orientation resulted in closer international trade and financial linkages, the economic performance and growth prospects of many developing countries had been greatly enhanced. The adoption of outward-oriented policy strategies and the accompanying liberalization of international trade and payments have been critical ingredients of successful economic development.[116]

Certainly, there is a very broad recognition of the benefits of global financial markets: they give countries new opportunities to quicken the pace of investment, job creation, and growth. They give investors a wider range of investment opportunities and higher returns on savings; they promote a more efficient allocation of resources worldwide and thus, stronger world growth. Global financial markets also provide countries with additional incentives to pursue sound macroeconomic policies and overcome structural weaknesses that impede investment and growth. Yet, there is also apprehension about the very serious risk associated with globalization. Indeed, countries today are more vulnerable to shifts in market sentiment regarding their economic situation or policies. Changes in market perceptions can trigger massive shifts in capital that can, in turn, precipitate banking sector crises and have serious spillover effects in other economies. Moreover, some countries are not well equipped to take advantage of expanding world trade and capital flows. Therefore, risks become marginalized from the world economy. Present developments in Southeast Asia show that these risks are significant.[117]

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[116] *Anne O. Krueger, Trade Policy and Economic Development: How We Learn, American Economic Review, Vol. 87 March 1997.*

[117] *Michel Camdessus, The Asian Financial Crisis and the Opportunities of Globalization, Address at the Second Committee*

Developments in the advanced economies and global financial markets also contributed significantly to the build up of the imbalances that eventually led to the crisis. Specifically, with Japan and Europe experiencing weak growth since the beginning of the 1990's, attractive domestic investment opportunities have fallen short of available savings; meanwhile, monetary policy has remained appropriately accommodative, and interest rates have been low. Large capital flows to emerging markets were driven to an important degree by this phenomena, and by an imprudent search for high yields from international investors, without due regard to potential risks. Also contributing to the build up to the crisis were the wide swings of the yen / dollar exchange rate over the past three years and the associated risks.[118]

Mr. Summer likened the capital markets to a jet plane.

> We can go where we want much more quickly, we can get there more comfortably, more cheaply and most of the time more safely but the crashes when they occur are that much more spectacular.

It is an arresting simile. Another obvious comparison is with the oceans. Sometimes, they are completely calm. But if one is trying to cross them in safety, one needs a sound boat. And even then, it might be overwhelmed if the waves are high enough.[119] Several conditions can lead to financial instability. First, when capital markets are liberalized, they create the potential for vast international movements of financial assets. Second, when

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of the United Nations General Assembly, New York, October 31, 1997, IMF.

[118] *Stanley Fischer, The Asian Crisis: A View from the IMF.*

[119] *Martin Wolf, Capital Punishment, Financial Times, March 17,1998.*

countries keep their exchange rates pegged, they create the perception that there is little risk involved in moving funds from one market to the other. Third, problems can occur when the monetary regime (including the system of regulatory control) is not adapted to the new regime of liberal capital market. Even though they do not always lead to disaster, it is fair to conclude that these three factors substantially increase the probability of the problem.[120]

[120] *Paul De Grauwe, Economic and Monetary Turmoil, Financial Times, February 20, 1998.*

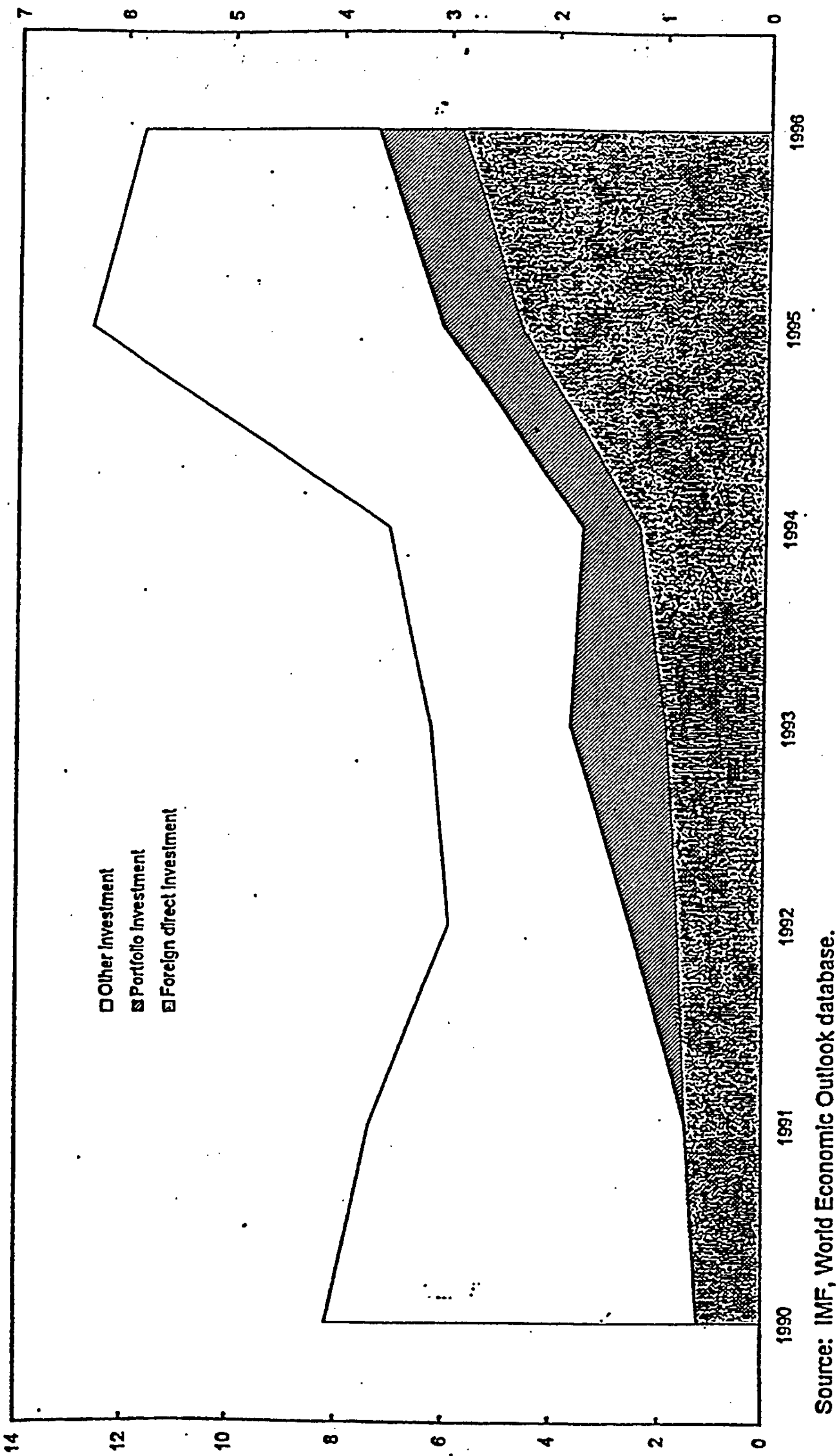
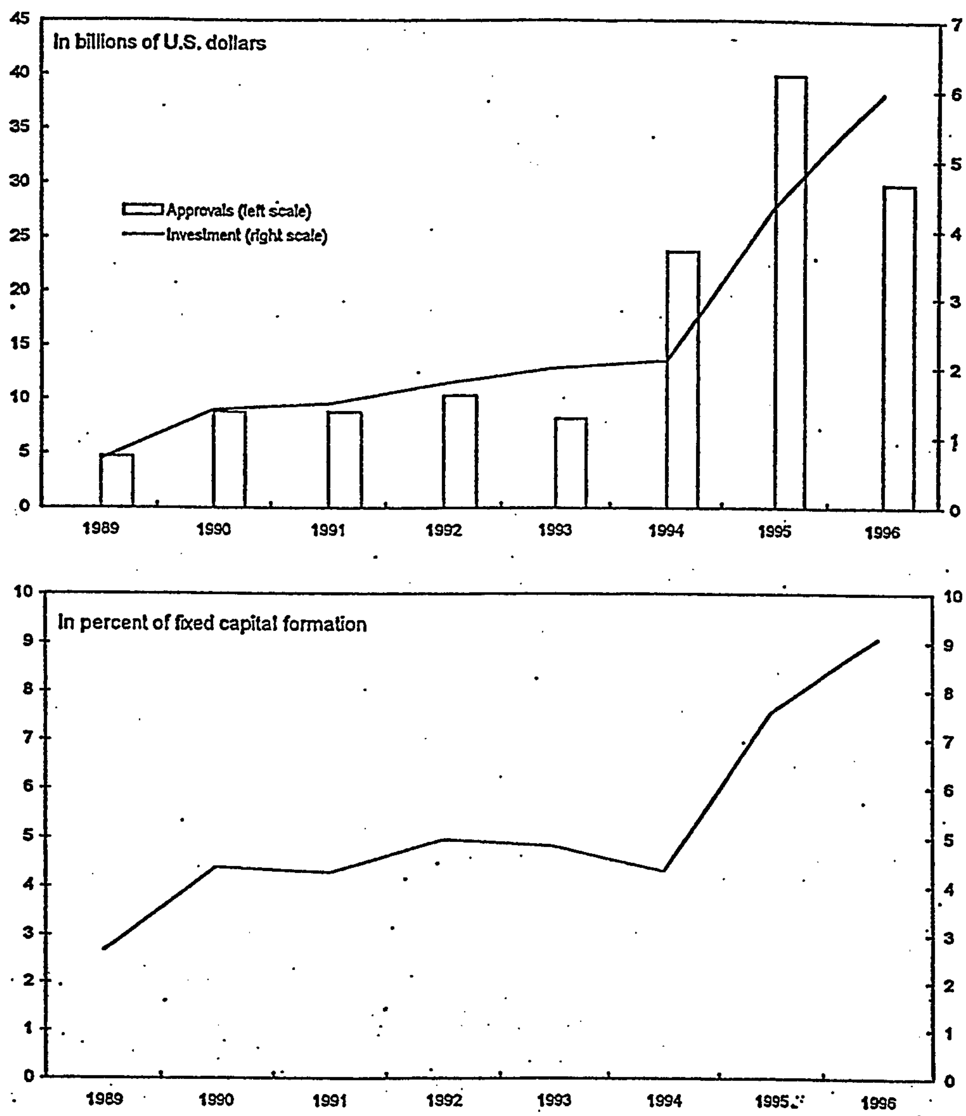


Figure 4.1 Composition of Capital Flows, 1990-96
(In billions of U.S. dollars)



Source: Data provided by the Indonesian authorities.

Figure 4.2 Foreign Direct Investment, 1989-96

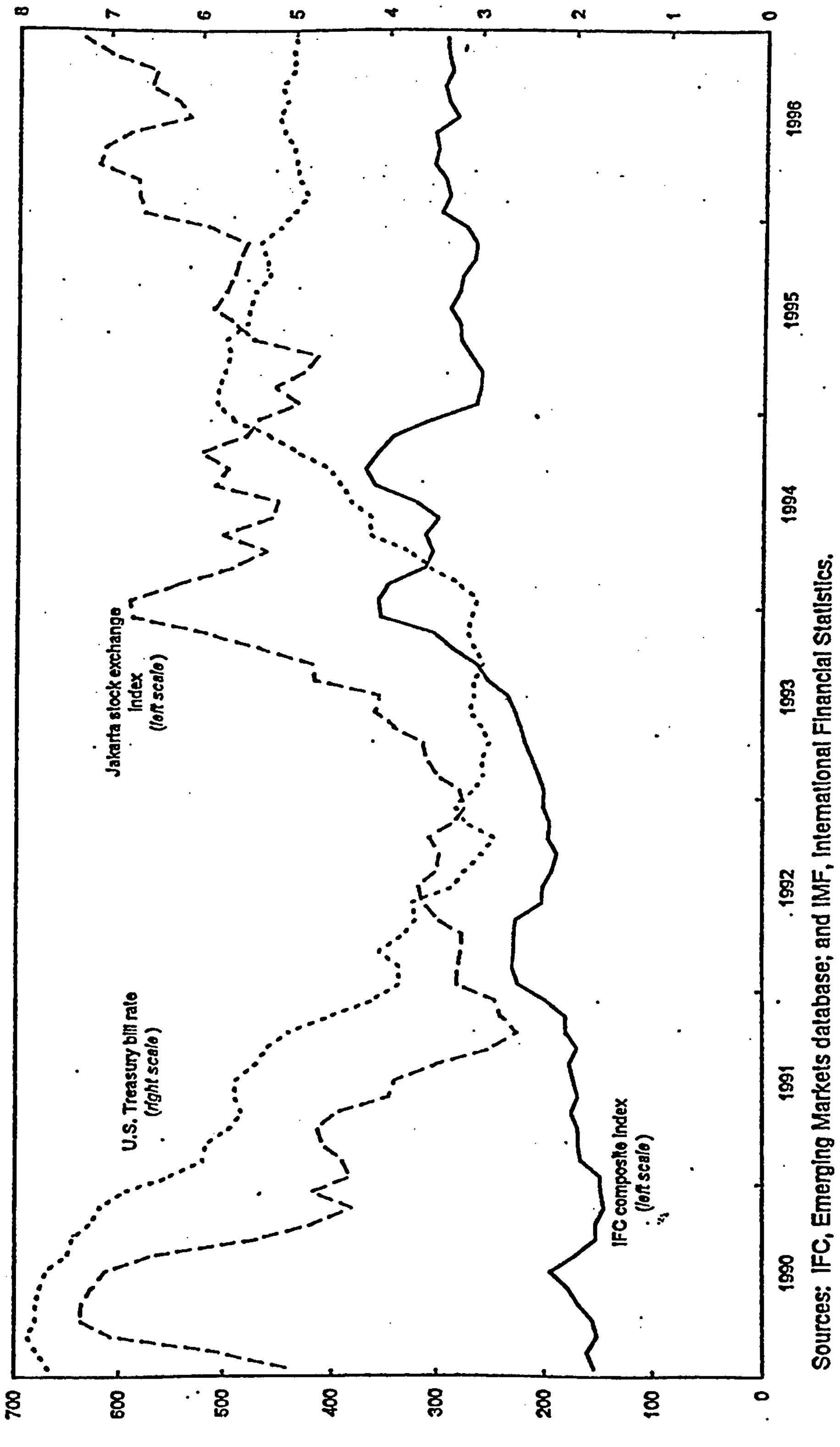


Figure 4.3 Stock Prices in Emerging Markets and United States Interest rates, 1990-96.

E. INVESTORS AND PANIC-STRICKEN LENDERS

Prior to the crisis, high volumes of international capital, together with a strong performance by major borrower countries, produced a sharp rise in commitments (including syndicated loans and bond issues) to developing countries. According to the World Bank, commitments from January to September exceeded the 1996 total by 10%, and portfolio equity flows increased strongly, accompanied by booming stock markets in Latin America and Eastern Europe. Over the year as a whole, net long-term private flows rose for the seventh straight year to reach a total of $ 256 billion, up from $247 billion in 1996. In 1997, developing countries relied on sophisticated market instruments more often than in the past, including greater use of derivative instruments and emerging markets mutual funds, and instruments to attract institutional investors and encourage greater participation by private firms.[121]

After viewing Asia for years as a promised land for lending and investing, despite growing signs of trouble, western financial institutions panicked last fall and shut down the flow of new capital to troubled countries. A study prepared for the world's major banks, documents how within the span of a few months, foreign banks and investments companies did a U-turn from greed to fear, slashing new loans and investments to the five most troubled Asian countries by $100 billion. That amount equals two-thirds of the new money funneled to Asia the prior year.[122] As the

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[121] *The World Bank Group, East Asia Financial Crisis Leads To Tumultuous Year In Emerging Markets, News Release No. 98/1683/S, March 24, 1998.*

[122] *Edmund L. Andrews, Report: Banks Shut Off Capital to Asia Last Fall as Greed Turned To Fear, The New York Times, January 30, 1998.*

Washington-based Institute for International Finance notes, net private flows to Indonesia, South Korea, Malaysia, the Philippines and Thailand jumped from $48 billion in 1994 to $93 billion in 1996 then collapse to an estimated minus $12 billion last year (1997).[123] The eastern Asian crises were triggered and exacerbated partly when investors found out that reserves were smaller than they had thought, and that short-term debt was higher. Perhaps more important than misleading information was the general lack of information. When the problems became apparent, information limitations made it hard for lenders to distinguish bad companies from good, leading them to shy away from all companies.[124]

As capital flooded out, exchange rates collapsed and bankruptcy engulfed the private sector. Countries found themselves at the mercy of panic-stricken private lenders and demanding official ones. Prof. Jeffrey Sachs from Harvard said that the investors were not so stupid, the trouble was that panic, albeit rational for each individual institution, turned a necessary, ideally quiet modest, adjustment into a catastrophe.[125] Moreover, the inflows had exacerbated the economies' underlying weaknesses. Large-scale inflows raised the real exchange rate, created current account deficits, lowered domestic interest rates and exacerbated overheating. Inflows were a response to past triumphs and transmuted them to disaster.[126] Despite the

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[123] Financial Times, East Asian Shipwreck, February 16, 1998.

[124] *Joseph E. Stiglitz, Boats, Planes and capital flows, Financial Times, March 25, 1998.*

[125] *Steven Radelet and Jeffrey Sach, The onset of the East Asian Financial Crisis, Harvard Institute for International Development, 1998, mimeo.*

[126] *Martin Wolf, Capital Punishment, Financial Times, March 17,1998.*

current crisis in Indonesia, investors' interest concerning investment in Indonesia was still high. According to the Minister of investment/chief of the investment coordination chamber, Sanyoto Sastrowardoyo, there were 815 projects with the value of RP 100.7 trillion in 1996 undertaken by Indonesian companies and 959 projects with the value of $29.9 billion undertaken by foreign companies. In 1997, there were 728 projects with the value of Rp 119.9 trillion undertaken by Indonesian companies, and 790 projects with the value of 33.8 billion undertaken by foreign companies. In 1998, through February, there were 227 foreign projects, 80 from the mining sectors. Despite the crisis, foreign investors were still willing to invest in Indonesia. [127]

F. SPECULATIVE ATTACKS

The wild fluctuations in the world stock markets, since July 1997 have highlighted the risks and potential dangers of an increasingly globalized financial system and currency speculation. The rapid and continuing integration of emerging market countries into global financial markets during the 1990's was accompanied by several currency crises. When the financial crisis occurred in Thailand in July 1997, then spread to other countries in the region, Dr. Mahathir Mohamad, the Malaysian Prime Minister, raised his voice against currency speculators (singling out George Soros and his `Quantum Fund' for speculative attacks to punish ASEAN countries for their policies towards Myanmar) and called for international actions to make such speculation and `sabotage' a criminal offence.[128] On July

[127] *Kompas, Meninvest: Investasi Asing Meningkat, February 8,1998.*

[128] *Chakravarthi Raghavan, Developing Countries Should Retain Some Capital Controls, Third World Network No. 86, October 1997.*

27,1997, he told the media in Alor Star, a northern Malaysian town, , that the international community should make sabotaging of currencies by financial speculators a crime. `Otherwise the currencies of developing countries will continue to be sabotaged. This phenomenon will be repeated, and it is for this reason that we must regard it as a crime.'

Earlier, leaders of ASEAN accused financial speculators for causing the recent fall in the value of their currencies and pledged to work together to combat the threat.[129] In his paper about `Currency Crises', Krugman agreed that what forced Thailand to devalue its currency was massive speculation against the bath, speculation that over a few months had consumed most of what initially seemed an awesomely large war chest of foreign exchange. And why were speculators betting against Thailand? They expected the bath to be devalued, of course.[130]

In a press conference at the Hong Kong Convention and Exhibition Center on September 25, 1997, Michel Camdessus, Managing Director of IMF addressed the international speculators' attack:

> We have witnessed here a formidable, temporary, but very strong pressure of speculation. What I would say is that when you see speculation somewhere, you must ask yourself why, as speculators never like to lose money. If they speculate, it is because they see somewhere a weakness or rigidity, which would make them very safe conditions for making money. So, if speculation is part of market life, what this crisis tells us is that you should not try to outlaw speculators, because you will create only parallel circuits for speculation. What you must do, with a sense of urgency, is to compete for excellence in the management of your economy in

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[129] *Martin Khor, Currency Sabotage Should Be An International Crime, Third World Network Features, August 1997.*

[130] *Paul Krugman, Currency Crises.*

> such a way that you will not attract the attention of the speculators and that they would not dare to speculate against you.[131]

Speculative currency attacks are not a uniquely modern phenomenon. Historically, they have occurred during periods characterized by high capital mobility and fixed exchange rates for example, the gold standard era and the 1920s. Then as now, investors and lenders responded swiftly and abruptly to bad news about political or economic crises in a given country, launching speculative attacks on the country's gold reserves. Recent empirical studies have determined that attacks (both direct attacks and those that represent the contagion effect of an attack on another currency) were most likely to target the currencies of countries with certain characteristics: a highly overvalued real exchange rate, a weak financial system and fiscal position, and an external debt position with a high proportion of short-term maturities.[132]

In Indonesia, the crisis was not only made by the foreign speculators but also by domestic speculators. When they saw certain indications that made them feel unhappy or panicked, such as banking problems, social unrest, political uncertainty, continuing depreciation of the rupiah against the U.S. dollar, etc., they quickly withdrew their money from banks and changed their rupiah to dollars. This created a massive rush in exchange money that plunged the value of rupiah against the U.S. dollar.

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131 *Michel Camdessus, Press Conference at Hong Kong Convention and Exhibition Center, IMF, September 25, 1997).*

132 *IMF Research Department Staff, Capital Flow Sustainability and Speculative Currency Attacks, Finance & Development / December 1997.*

G. SOCIO POLITICAL, DROUGHT AND FOREST FIRES

In the 30 years of New Order, political stability was always taken for granted, but the recent increase of political uncertainty and a prolonged drought caused by El Nino contributed to the financial crisis in Indonesia. The increasing degree of uncertainty and anxiety had been triggered by underlying socio political factors, such as widening socio economic inequality, elections in the mid-1997 general assembly in March 1998, and the issue of political succession. In ECONIT: Economic Outlook 1997, the ECONIT Advisory Group concluded that 1997 is a Year of Uncertainty. It was so named because there were many unpredictable factors in domestic politics, which would have a strong and direct impact on the economy approaching the year 2000. The increasing degree of uncertainty originated from a number of factors, such as increasing frequency of inconsistent policies, as well as increasing errors of judgement in economic and political decision-making.

ECONIT also mentioned that a number of factors had contributed directly to the rising degree of uncertainty. First, there was an increasing tendency toward fragmentation in the decision-making process and increasing weakness in government policy responses. One clear example was the fragmentation and clear differences in opinion within the members of the cabinet on the Fiscal Team over the case of a tax holiday. Second, there was a rising tendency toward highly centralized and personalized decision-making in both politics and economy. The excessive centralization and personalization in decision-making increased errors of judgement. Third, increasing political re-alliances and jockeying, both before and after the election, pushed economic issues to the back burner. At the same time, increasing budgetary and non-budgetary spending was mobilized to guarantee the political status quo. This increased spending minimized the effectiveness of monetary contraction.[133]

Several riots and social unrest in some regions, before and after Election Day in May 1997, made investors and markets worry about stability in Indonesia. Demonstrations/riots in several Universities and burning and looting at some shops owned by ethnic Chinese worsened the situation and caused fluctuations in the rupiah. Rumors about the health of President Soeharto in October 1997, and when he decided not to attend the ASEAN summit in Malaysia, caused the rupiah to nosedive to Rp5,800 per U.S. dollar on December 15, 1997. This represented an 11% depreciation in a single day. Concern about who would be the new vice president also depreciated the rupiah. When the ruling party, GOLKAR, announced the expected criterion of the future candidate of the vice president, which clearly indicated B.J. Habibie, markets reacted negatively and caused the rupiah to decrease further against the dollar.

H. FOREIGN EXCHANGE REGIME

One of the key domestic factors that led to the present difficulties appears to have been maintaining pegged exchange rates for too long, which encouraged external borrowing and led to excessive exposure to foreign exchange risk in both financial and corporate sectors.[134] In recent months, financial crises focused attention on the role of the exchange rate regime. Since the 1970s, developing countries have followed a gradual but significant shift from

[133] *ECONIT: Economic Outlook 1997, Indonesian Economy 1997: Year of Uncertainty.*

[134] *Stanley Fischer, The Asian Crisis: A View from the IMF, Washington, D. C., January 22, 1998.*

fixed exchange-rate systems (pegging to a single currency, such as the dollar, or to a basket of currencies) toward more flexible exchange rates arrangements. Countries have tended to move away from the pegs they originally adopted after the industrial countries switched to floating rates in the early 1970s, and have instead introduced arrangements that allow more frequent adjustments, such as exchange rate bands, managed floats, or floating exchange rates. In the mid-1970s, 86% of developing countries had some type of pegged exchange rate. At the end of 1996, fewer than half did. Almost one-third of countries now claim to have independently floating rates.

The basic argument about the benefits of the flexible exchange rates was to increase the flexibility in exchange rate management for external shocks that require domestic adjustment. Flexible exchange rates make it easier for an economy to adjust to external shocks which widened a country's trade deficit, such as a rise in the oil prices. A flexible exchange rate also allows countries to target monetary policy to domestic ends, such as price stability, rather than having to use interest rates to maintain inflexible exchange rates.

But flexibility has disadvantages as well. The most important are that exchange rates can be volatile and, on occasion, grossly misaligned. This can hinder trade and upset the economy.[135] In World Economic Outlook December 1997, the IMF stated:

> Indeed, while there are many examples of pegged exchange rate regimes functioning reasonably well for extended periods, there are also numerous examples of pegged exchange rates being adjusted too late in the face of capital inflows that ultimately proved destabilizing. Greater

[135] *The economist Newspaper, Getting Out Of A Fix, The economic Newspaper Limited,1998.*

willingness to let the exchange rate move in response to changing circumstances may also help convey a more realistic perception of risk to both domestic and foreign investors.[136]

Central banks in Thailand, the Philippines, Malaysia and Indonesia have succumbed to currency speculators in recent months and have abandoned their policies of pegging their currencies to a basket of currencies dominated by the U.S. dollar. The currency pegging policies became vulnerable because of ballooning trade deficits.

With the growing international mobility of capital after the 1970s, however, it became increasingly clear that there were substantial stocks of capital that were prepared to move en masse from one currency to another. Countries that tried to fix their exchange rates could find their reserves (or, in the case of surplus countries, their patience) quickly exhausted by massive speculative attacks; countries with floating exchange rates found that those rates fluctuated with the expectations of speculators.[137]

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[136] *IMF, World Economic Outlook, Interim Assessment, December 1997, International Monetary Fund.*

[137] *Paul Krugman, Currencies and Crises, p.xiv-xv, 1992, the MIT Press, Cambridge, Massachusetts, London, England.*

V. SUMMARY AND CONCLUSIONS

A. SUMMARY

The Republic of Indonesia has achieved remarkable economic development success over the past several decades and is considered to be among the best performing East Asian economies. With abundant natural resources and a population of 200 million, prudent macroeconomic policies, high investment and saving rates, and continuing structural reforms to liberalize markets have kept Indonesia on a path of rapid economic development. Since the 1970s, economic growth has averaged 7 percent per annum, a growth performance that ranks among the ten fastest in the world, and attained real Gross Domestic Product (GDP) growth of 7.8 percent in 1996. The economic structure has become diversified, as dependency on the oil sector has declined and an export oriented manufacturing base has emerged, led by a dynamic private sector and fueled by high domestic savings and large inflows of foreign direct investment.

The Indonesian economy continued to perform well in 1996 and in the beginning of 1997. Macroeconomic balance was maintained: the budget was balanced; inflation was contained at relatively low levels; current account deficits were moderate; and international reserves remained at comfortable levels. The rate of inflation in 1996/1997 fell to 5%, and there was a budgetary surplus for 1996/1997 equalling 1% of GDP. The overall balance of payments was estimated to have registered a surplus of US$6.1 billion in 1996/1997, compared with US$3.4 billion in 1995/1996. The external current account deficit in 1996/1997 widened to 3.5% of GDP and official reserves increased to the equivalent of six months of imports in 1996/1997. Foreign exchange reserves, as of April 1997, had reached US$20.38 billion. As of early 1997, foreign debt has reached US$110 billion, US$56 billion owed by the government and US$54 billion by the private sector.

In the banking sector, the number of commercial banks increased from 111 to 240 between 1988 to 1994. A liberal capital account regime and regulatory changes over the past decade have all contributed to fast changes in Indonesia's banking sector. The seven state banks dominated the sector, with their combined assets accounting for about 45% of the entire system, although their share of total lending has declined markedly in recent years. The private commercial banks have grown faster than the state banks, which accounted for about 30% of the total banking system assets in the mid-1997. There were also 9,300 rural banks, which are limited in both their geographical area of operations and their banking activities. The nonbank financial sector, including savings banks, mutual funds, pension funds, insurance companies, and leasing companies, has continued to develop.

Large private sector banks were generally well managed and competitive, but the soundness of the banking system, especially for the state banks and smaller banks, had been of concern. Foreign currency borrowings showed substantial growth between 1988 and 1996, and foreign currency deposits also grew rapidly. There had been a rapid expansion in lending to the property sector, and most property projects utilized short-term loans to finance development. Indonesian companies were also borrowing heavily in international capital markets. Bank Indonesia, the central bank, had taken several steps to strengthen the banks, such as, including increasing moral suasion to restrain overall credit growth, including the stricter limits for individual banks, based on their level of capital and riskiness of their lending portfolios.

Before June of 1997, with the economic environment as explained previously, it was difficult to predict that the Indonesian economy would deteriorate rapidly. When the economic crisis hit Thailand in July of 1997, Thailand had to devalue their currency by changing their foreign exchange regime from a dollar peg to floating. It triggered other countries in Southeast Asia (including Indonesia) to devalue and float their currencies. However, Indonesia was still considered in good condition. Even when Indonesia felt the pressure of the crisis in October of 1997, analysts said that Indonesia's macroeconomic foundation remained sound, despite recent pressures in the foreign exchange markets. At the same time, Thailand's economic crisis deepened; the spillover spread beyond the Southeast Asian countries to regions such as Hong Kong and South Korea.

Unfortunately, Indonesian economics were not immune to the crisis. The situation gradually worsened. Indonesian currency continued to depreciate and the stock market was volatile. The government introduced several reform packages and asked for economic assistance and advice. The IMF agreed to provide US$40 billion in financial assistance. The crisis deepened in January of 1998 after the government announced the fiscal 1998-1999 Central Government Budget that failed to convince the market that Indonesia was committed to reforming its economy. After the government revised its budget and signed a new agreement with the IMF, Indonesian currency, fell to a record low of Rp17, 000 to the U.S. dollar. Bank Indonesia intervened by selling the dollar; soon the rupiah rose to Rp11,800.

The IMF package showed no signs of alleviating Indonesia's debt and confidence about the market and economic conditions became very weak. Stocks prices were falling and the rupiah had plunged into an abyss. With each downward spiral of the currency, Indonesia's foreign-debt burden grew bigger. It became difficult for many companies to pay their debt. The financial and currency crisis forced many companies in to bankruptcy, unemployment was on the rise, the price of food and other products were increasing, and some economists predicted that millions of Indonesians would be dragged back below the poverty line, reversing decades of progress.

The crisis also has heightened the likelihood of social unrest. There were riots in several places, students in many universities participated in peace demonstrations on their campuses, and people called for President Suharto to step down. This was the worst economic crisis in Indonesia since 1965.

The causes of the crisis can be explained by several factors:

1. Start from Thailand. The crisis began in Thailand, where there were numerous signs of impending crisis. Macroeconomic indicators pointed to substantial imbalances: the real exchange rate had appreciated substantially; export growth had slowed markedly; the current account deficit was consistently large and was increasingly financed by short-term inflows; and external debt was rising quickly. The bulk of the increase was in the most volatile type of debt, short-term bank loans. Thailand became the country with the largest debt increase in 1994 and 1995. Thailand economic weaknesses also included unhedged foreign borrowing by the private sector, an inflated property market, and a weak and over-exposed banking system. On July 2, 1997, after increasing exchange market pressure and a desperate defense of the currency by the central bank, Thailand had to devalue its currency by abandoning the dollar

peg and adopting the floating rate regime. The economic crisis broke and spread to other countries.

2. Contagion/Spillover Effects. Once the crisis hit Thailand, the contagion to other economies in the region appeared relentlessly. After their experience in Thailand, markets began to take a closer look at the problems in other neighboring countries. The market signaled some of the problems in Indonesia as found in Thailand, particularly in the financial sector. Some contagion reflected rational market behavior. The depreciation of the Thailand currency, bath, could be expected to erode the competitiveness of Thailand's trade competitors, and put downward pressure on their currencies. The contagion/spillover effect spread quickly to other countries in the region. The Philippines, after seeking briefly to defend its currency peg through interest rate hikes and intervention, finally allowed the peso to float on July 11, 1997. In Malaysia, the authorities opted to allow the ringgit to depreciate rather than raise interest rates. Indonesia adjusted its intervention bands and raised its interest rates, however, measures to tighten liquidity conditions in Indonesia failed to stem the growing exchange market pressures. Finally the government allowed the rupiah to float on August 14, 1997. As the crisis deepened, contagion/spillover effects spread to other countries in Asia. The Singapore dollar and New Taiwan dollar weakened moderately. The Hong Kong dollar also came under attack. The most sensational casualty was South Korea, the eleventh

largest economy in the world. They began to have economic problems and had to ask for a financial bailout from the IMF.

3. Structural Weaknesses, Debt and Crisis of Confidence. Despite Indonesia's strong economic performance over the past several decades, which has ranked among the best in the developing world, Indonesia has a number of underlying structural weaknesses. These made them vulnerable to adverse external developments. Some of the weaknesses are long-standing rigidities in the form of domestic trade regulations, and import monopolies that impeded economic efficiency and competitiveness. At the same time it was unclear how decisions were made that affected the business environment and data deficiencies, increased uncertainty and adversely affected investor confidence. Large capital inflows, intermediated through a weak banking system, exposed Indonesia to a shift in financial market sentiment. Indonesia's banking sector was not prepared to withstand the financial turmoil.

   The financial sector lacked proper prudent standards and supervision. The relative stability of the rupiah during most of the 1990s, together with high rates of return on domestic investment, both encouraged and facilitated high levels of overseas borrowing, a significant portion of which was private short-term debt that was unhedged. By the end of December 1997, Indonesia's external debt stood at US $140 billion (about two-thirds of GDP), of which US $20 billion was short-term. With the fall of the rupiah, companies were unable to repay their foreign debts and became bankrupt.

Such structural problems take time to resolve, and involve high social costs.

4. Globalization and Integration in Financial/Capital Markets. The globalization and integration in financial/capital markets has progressed significantly and has promoted a better distribution of world savings during the last decade. Improvements in communications and technology significantly decreased transaction costs and increased international capital movement. Cross-border-transactions in bonds and equities increased. The daily turnover in the foreign exchange market expanded. The liberalization of the economies, the high growth performance and relative macroeconomic stability in most developing countries, rapidly expanded capital flows.

As globalization and changes in policy orientation have tightened international trade and financial linkages, the economic performance and growth prospects of many developing countries have been greatly enhanced. Some benefits from globalizing and the integrating financial markets have given countries new opportunities to accelerate investment, job creation, and growth and give investors a wider range of investment opportunities and higher returns on savings, etc.

Despite these benefits, globalizing and integrating financial markets also created very serious risks. Countries were more vulnerable to shifts in market sentiment regarding their economic situation or policies. Changes in the market triggered massive shifts in capital that could, in turn, precipitate banking sector crisis and have serious spillover effects in other economies. Countries that were not well equipped to take advantage of expanding world trade and capital flows risked becoming marginalized from the world economy.

5. Investors and Panic-stricken Lenders. Prior to the crisis in Southeast Asia, high volumes of international capital, together with a strong performance by major borrower countries, produced a sharp rise in commitments (including syndicated loans and bond issues) to developing countries. The developing countries in Southeast Asia relied on sophisticated market instruments more often than in the past, including derivative instruments, emerging market mutual funds, and instruments to attract institutional investors and encourage greater participation by private firms.

   After viewing Asia for years as a Promised Land for lending and investing, despite growing signs of trouble, the world financial institutions panicked last fall and shut down the flow of new capital to troubled countries. A study documents how within the span of a few months, foreign banks and investment companies did a U-turn from greed to fear. The crises were triggered and exacerbated partly when investors found out that reserves were smaller than they had thought and that short-term debt was higher. When the problems became apparent, it was difficult for lenders to distinguish bad companies from good, leading them to shy away from all.

As the capital flooded out, exchange rates collapsed and bankruptcy engulfed the private sector, countries found themselves at the mercy of panic-stricken private lenders and demanding official ones. The trouble was that panic, albeit rational for each individual institution, turned a necessary, ideally quiet modest, adjustment into a catastrophe.

6. Speculative Attacks. Speculative currency attacks are not a uniquely modern phenomenon. Historically, they have occurred during periods characterized by high capital mobility and fixed exchange rates-for example, the gold standard era and the 1920s. Then as now, investors and lenders responded swiftly and abruptly to bad news about political or economic crisis in a given country, launching speculative attacks on the country's gold reserves. Recent empirical studies have determined that attacks (both direct attacks and those that represent the contagion effect of an attack on another currency), were most likely to target the currencies of countries with certain characteristics. These were a highly overvalued real exchange rate, a weak financial system and fiscal position, and an external debt position with a high proportion of short-term maturities. In Indonesia, the crisis was not only percipitated by foreign speculators, but also by domestic speculators. When they identified certain indicators, including banking problems, social unrest, political uncertainty, continuing depreciation of the rupiah against U.S. dollar, etc., they quickly withdrew their bank deposits and changed their rupiah to dollars or other

strong currencies. This created a massive rush in exchange money significantly depreciating the value of rupiah against the U.S. dollar.

7. Socio Political Drought and Forest Fires. The socio political situation, during 1997 and in the beginning of 1998, was full of uncertainty. Increasing uncertainty and anxiety has been triggered by some underlying factors, including widening socio economic inequality, elections in mid-1997, general assembly formation in March 1998, the issue of political succession and uncertainty in identifying the vice president. Several riots, demonstrations and social unrest in some regions, before and after both Election Day in May of 1997 and forming the general assembly in March of 1998, concerned investors and markets about circumstances in Indonesia. This also depreciated the rupiah. Forest fires in parts of Indonesia, especially on the Sumatera Island and Kalimantan islands, and prolonged drought caused by El Nino, destroyed many agricultural harvests and worsened the situation.

8. Foreign Exchange Regime. In recent months, the financial crisis has focused attention on the role of the exchange rate regime. One of the key domestic factors that led to the economic crisis appears to have been the prolonged maintenance of pegged exchange rate regimes. This encouraged external borrowing and led to excessive exposure to foreign exchange risk in both financial and corporate sectors. With the growing international mobility of capital during the last decades, it became increasingly clear that substantial stocks of capital are prepared to move en masse from one

currency to another. Countries that fix their exchange rates could find their reserves (or, in the case of surplus countries, their patience) quickly exhausted by massive speculative attacks. The Indonesian central bank, Bank Indonesia, together with central banks in Thailand, the Philippines and Malaysia have succumbed to currency speculators and have abandoned their policies of pegging their currencies to a basket of currencies dominated by the U.S. dollar. The currency pegging policies became vulnerable because of ballooning trade deficits.

B. CONCLUSION

After achieving remarkable economic success over the past several decades and considered to be among the best performing East Asian economies, Indonesia has faced financial and currency difficulties. The financial and currency crisis was sparked by the sharp depreciation of the Thailand bath, which in turn triggered similar downturns in the Philippine peso, Malaysian ringgit, Indonesian rupiah, and even the Singapore dollar. The crisis then spread to other regions, including Hong Kong and South Korea. The crisis in Indonesia occurred because of several factors. It started from the Thailand crisis, which triggered subsequent crises in other Southeast Asian countries through contagion/spillover effects. The crisis was worsened by Indonesia's structural weaknesses, debt crisis and loss of confidence within the markets; globalization and integration of the financial/capital market; investors and panic-stricken lenders; speculative attacks; socio political issues; drought and forest fires; and the foreign exchange regime, which prolonged the pegged exchange rate.

C. RECOMMENDATIONS FOR FURTHER RESEARCH

- Indonesia's economic situation after March 1998.
- The impact of the financial and currency crisis in Indonesia and in other Asian countries on global financial markets.
- Financial and banking system relationships under alternative foreign exchange regimes.
- The flows of international capital funds and their regulation.
- Speculative attacks, how they work, and how to best protect such attacks.

APPENDIX A

ABREVIATIONS AND DEFINITIONS

ADB = Asian Development Bank

AFTA = ASEAN Free Trade Area

APEC = The Asia-Pacific Economic Council

ASEAN = The Association of South-East Asian Nations

BAPPENAS = Badan Perencanaan Pembangunan Nasional, National Development Planning Board

BI = Bank Indonesia, central bank

BIS = Bank for International Settlements

BKPM = Badan Koordinasi Penanaman Modal, Investment Coordinating Board

BPIS = Badan Pengelola Industri Strategis, Strategic Industries Board

BPS = Biro Pusat Statistic, Central Bureau of Statistics

BULOG = Badan Urusan Logistic, National Logistic Agency, government food price Stabilization agency, particularly rice procurement

BUMN = Badan usaha milik negara, state-owned enterprises

CAD =Capital Adequacy Directive

CAR = risk-adjusted capital adequacy requirement

CBA =Currency board arrangement

CGI = Consultative Group for Indonesia, replacing IGGI in 1992

CPI = Consumer Price Index. CPI is a measure of the average change over time in the Prices paid by urban consumes for a fixed market basket of consumer goods and Services from A to Z

ERM = exchange rete mechanism

FDI = Foreign direct investment

G-7 = Group of Seven

G-10 = Group of Ten

GDP = Gross Domestic Product. GDP is a measure of the total production and Consumption of goods and services

GNP = Gross National Product

GOLKAR = Golongan Karya, government political party

IMF = The International Monetary Fund

IGGI =Inter-Governmental Group for Indonesia, the international donor consortium, in Existence until 1992

JSE = Jakarta Stock Exchange

LIBOR = London interbank offered rate

LOLR = The lender of last resort

MOU = Memorandum of Understanding

NAM = Non-aligned Movement

NASDAQ = National Association of Securities Dealers Automated Quotation

NDA = Net domestic assets

New Order/Orde Baru = refers to the period since the commencement of President Suharto's rule, generally taken from March 1966, although Sometimes interpreted in a constitutional sense to be from 1967

NIES = The Newly Industrialized economies

OECD = Organization for Economic Cooperation and Development

OPEC = Organization of Petroleum Exporting Countries

OTC = over-the–counter market

PPI = Producer Price Index. PPI measures average changes in selling prices received by Domestic producers for their output. The PPIs track the rate of price change in the manufacturing, mining, agriculture, and electric utility industries. The PPIs most often used for economic analysis are the three stage-of-processing indexes, composed of: finished goods, intermediate goods, and crude goods

PPP = purchasing power parity

Rp = rupiah, Indonesian money

SBI = Sertificat Bank Indonesia, Bank Indonesia certificate, a security issued by Bank Indonesia

SBPU = Surat berharga pasar uang, money market security that can be sold to Bank Indonesia

S&P = Standard and Poor's

VAR = Value at risk

VAT = value-added tax

VRR = Value Recovery Rights

WTO = World Trade Organization

APPENDIX B

BRIEF NEWS IN APRIL-MAY 1998

April 11th: General Wiranto met some youth leaders and reiterated his warning to stay off the streets.

April 16th: Thousands of students hold campus protests.

May 1st: President Suharto said that political reform cannot come, constitutionally, before 2003.

May 4th: The government raised fuel prices 71%. Riots broke out in the North Sumatran capital of Medan, six die.

May 9th: President Suharto left for a week-long visit to Egypt.

May 12th: Six students were shot and killed at Trisakti University in Jakarta. Vice president, B. J. Habibie, expressed the government's "deepest condolences." The armed forces promised to investigate. The movement for political reform, carried along for three months by daily student demonstrations throughout the country, reached a turning point.

May 13th: Southeast Asian currencies (including the rupiah) and bourses weakened considerably because of the political fallout from Indonesia. Riots broke out in some part of Jakarta.

May 14th: President Suharto said any changes must be through constitutional means. Chaos reigns. Mob attacks and damaged buildings are linked to firms controlled by President Suharto's family and friends, and owned by ethnic Chinese.

May 15th: President Suharto returned and ordered ministers to act against rioters. The government reduced some oil prices.

May 16th: President Suharto pledged to shuffle cabinet soon. Hundreds of foreigners and ethnic Chinese flew out of Jakarta. The death toll from a week of rioting, arson and looting in Jakarta exceeded 500.

May 17th: The students occupied the national parliament building. They were planning to stay there until President Suharto resigned. They had widespread support from the people.

May 18th: Parliamentary Speaker Harmoko, a close associate of the president, called on Suharto to step down.

May 19th:President Suharto promised to step down but did not specify when.

May 20th: Suharto's Golkar party called on the president to resign

May 21st: President Suharto announced his resignation and vice-president B. J. Habibie became the new president. World leaders welcomed the resignation of President Suharto, and said the move could be a giant step toward democracy in the Asian nation, the world's fourth most populous country with some 202 million people. The rupiah closed in Asian trading at about 11,000 to the U.S. dollar, a level at which the economy can not function.

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