Chapter 6

Pre and Post Crisis Indonesia: The Vital Roles of Institutional Factors

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A. Introduction

When liberalised capital flows met with a weak banking system, and a contagion from the collapse of a neighbouring country's currency strike, even a fairly strong macroeconomic fundamental could not prevent the revelation of a country's institutional weaknesses and poor governance. They all became much more exposed. When the prevailing institutions were unable to catch up with the fibre optic speed of liberalised economy and capital flows, vulnerability turns into real crisis.

The speedy liberalised economy began since mid-1980s, the massive flows of capital occurred during 1990s, and the crisis started in the summer of 1997. Obviously, I am referring to the episode of the Asian crisis.

But since in this conference I was given a task to discuss specifically about the Indonesian case, I will refrain from elaborating the relevance of institutional factors in other countries that were hit by the crisis, although occasionally I will refer to other countries' statistics merely for comparison.

After arguing that putting the blame on macroeconomic fundamentals is misplaced (section B), the evolution of the crisis and its damaging social repercussions are discussed in section C. In the subsequent section, the paper specifically argues that the institutional factors played a vital role, yet undermined, in explaining the crisis in Indonesia. Questions are also posed in the same section pertaining to the myth of credit crunch and the effectiveness of using interest rate as a policy instrument to strengthen the currency. In section E, I discuss the general environment during the post-Suharto period (prior to the scheduled June 7 parliamentary election). In the concluding notes, I raise a number of issues regarding the need to reform domestic institutions and international financial architecture, and share my thoughts on the country's economic and political outlook.

B. Pre-Crisis Performance

Macroeconomic Achievements with Extensive Foreign Borrowings

Despite the major economic downfall during the second half of 1997, Indonesia's rate of economic growth for the entire year remained positive, i.e., 4.6 %. This was due to the fact that the economy grew by more-than 7% during the first half of the year.

If we look at the trend up to 1996, actually all countries in the region produced strong economic growth. Inflation rate was low, consistently at one-digit, primarily due to prudent monetary policy and persistent surplus in the government budget. In Indonesia, there was even a deflation during the month of July.

Exports from the region grew strongly, although the rate became moderate in 1996. Why? For one thing, there was a downturn in the semiconductor cycle, affecting exports particularly from Malaysia and Thailand. Furthermore, devaluation of the Chinese Yuan in 1994 (more-than 40%), stronger US dollar (all countries in the region pegged their currencies to the greenback), and massive capital inflows that put an upward pressure on the exchange rates, are all bad news for exports. Increased competition from other countries, including those from the new emerging markets, fuelled more difficulties.

On the other hand, growth of imports remained strong, as real investment grew significantly (the investment-GDP ratio ranged from 23% in the Philippines to a high 43% in Thailand and 31% in Indonesia).[1] As a result, the current account deficits (CAD) widened, although in Indonesia the figure was still less-than 5% (compare to over 8% in Thailand).

Even with a slower export growth, all countries in the region managed to maintain relatively large foreign reserves. Before July 1997, the recorded numbers in terms of months of imports were 5.5 for Indonesia (May), 6.3 for Thailand (April), 3.9 for Malaysia (last quarter of 1996), and 3.1 for the Philippines (May). The ratio of money supply (liquidity) to foreign reserves also did not show a serious sign of vulnerability, although it was relatively high in Indonesia.

A surge in commercial bank's credit occurred following the trend of massive capital flows, despite the fact that in some countries, particularly in Malaysia and Indonesia, the respective governments often conduct sterilisation in a fairly extensive manner.

But by far the sheer size of short-term private foreign debts creates more serious problems than the domestic credits. These debts alone can explain why pressures on the local currencies have been so persistent.[2]

A more worrying trend relates to the proportion of short-term debts (STD) to the size of foreign reserves (Forex). The greater the STD/Forex ratio, the more vulnerable to speculative attacks the country will be.[3] It is indeed the case that countries with a worse economic situation in the region were precisely those that had STD/Forex ratio greater than unity. In the Indonesian case, the ratio was 1.7 (see Azis, 1999).

Was Rupiah Overvalued?

In general, the usual claims on overvalued exchange rate are sensitive to the model specification of "equilibrium" (long-term) rate, from which the actual exchange rate deviates.[4]

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[1] Despite the region's high saving rate--over 30% of GDP--huge inflows of capital are still required to finance an even higher rate of investment. This sign of over investment raises the question about investment quality. It could suggest that the investment surge was a sign of weakness rather than strength..

[2] By the end of 1996, it was recorded more-than US$70 billion in Thailand, US$50 billion in Indonesia, and US$22 and US$13 billion in Malaysia and the Philippines, respectively. Unlike in Korea, most of these private debts were made by corporate (non-bank) sector, making the negotiation of debt restructuring more difficult to conduct. With the exception of the Philippines, the Japanese banks have the largest exposures in the region. The fact that by June 1997 the US banks had "only" US$4.6, US$4, US$2.8 and US$2.4 billion exposure in, respectively, Indonesia, Thailand, the Philippines and Malaysia, may suggest why the US government was not at its fullest capacity in helping the region, despite its robust state of economy.

[3] In all countries, STD was larger than the long-term borrowings. By summer 1997, the size of STD was US$46 and US$35 billion in Thailand and Indonesia, respectively.

[4] Even if one has a fairly good model, there is still a set of issues need to be resolved with respect to the relevance of econometric technique to be used (e.g., the presence of cointegration).

Using a simple Purchasing Power Parity (PPP) concept, Chinn (1998) found that prior to the crisis the Indonesian rupiah was undervalued by 5.5%. But the simplicity of PPP draws skepticism over such a result. To test the real effective exchange rate (REER), one has to specify a set of explanatory variables to determine the predicted value of an equilibrium exchange rate. Once determined, the deviation between such a value and the actual rate represents the size of currency overvaluation or undervaluation.

Goldman Sachs applied a technique along this line (by using a *Dynamic Equilibrium Emerging Markets Exchange Rate Model*) and found that prior to the crisis the rupiah was indeed overvalued, but the degree of overvaluation was very small, i.e., 1.2%.

Obviously, the selection of explanatory variables will determine the result. Using the index of terms-of-trade, the indicator of openness, and the ratio of government expenditure to GDP as relevant explanatory variables, Cerra & Saxena (1998) found that when the resulting equilibrium REER is compared with the actual REER, the rupiah was overvalued by 13% and 27% in 1996 and 1997, respectively.[5] Furthermore, when the ratio of government investment to GDP is removed (insignificant), the degree of overvaluation also dropped.

Although these figures are higher than those found by Chinn (1998) and Goldman Sachs (1998), when they are compared with the actual depreciation (correction), a mismatch is clearly found. The real depreciation of the rupiah during 12 month after the crisis was almost 70%! Hence, whichever figures or models are used, the subsequent real devaluation of the rupiah was not correlated with the initial overvaluation measures (overshoot).

Therefore, the claims on overvalued rupiah prior to the crisis being the determinant of the currency collapse does not seem to have a strong validity. In fact, if we use the figures from Chinn and Goldman Sachs, a rejection to the standard hypothesis that overvalued currency leads to currency collapse also applies to Thailand, Malaysia, the Philippines and Korea (see Goldfajn and Baig, 1998).

C. Evolving Crisis and Its Social Repercussions

Summertime Drama and the Downfall of Suharto

In Indonesia, the drama began a few weeks after the collapse of the Thai baht in July 1997. The resulting financial crisis evolved in stages. In the first stage, the baht devaluation created a serious jitteriness among foreign investors. Mutual fund managers and corporate treasurers from around the world began to sell local currencies, setting off a tumble not only in local currency but also in the stock market.

The Indonesian government responded by banning loans to property developers, limiting non-residents' transactions in forward markets and banks' net open positions, widening the exchange rate band from 8 to 12 percent, and actively defending the rupiah at the cost of depleted foreign reserves. In retrospect, this was an appropriate macroeconomic policy response but short of institutional reform. It was implicitly thought that by strengthening further the macroeconomic conditions the institutional constraints could be mitigated.

[5] They detected that all explanatory variables are non-stationary, with one cointegrating vector. After running a cointegrating equation using VAR-ECM, the results show that except for the ratio of government.expenditures to GDP, all other coefficients are significant.

But by that time the debt-equity ratio of many companies already reached an all-time high (officially recorded at around 200 percent, but the actual number is likely much higher due to marked-up equity values). The local corporate sector began to scramble buying greenbacks to meet repayment of their enormous dollar-denominated loans. Hence, in the subsequent stage, nervousness among local corporate sectors intensified the depreciation expectation.

It is obvious that the early pressures on the rupiah did not come from speculators (i.e., those who attempted to profit from the declining values of a currency). It was only at a later stage that they may have taken advantage by joining the flux, exacerbating the already slumped rupiah and further bruising the stock market.

During the early IMF rescue process, the importance of (formal) institutions was also neglected, but this time by the IMF. After a frustrating two weeks of discussions in October 1997, the government of Indonesia (GOI) reached an agreement with the IMF to come up with a reform package involving some 43 billion US dollar. A major step in the agreement was the decision to liquidate a number of banks, some of which were owned by well-connected businessmen and members of the Suharto family.

At the time, resistance to the IMF's request was strong. One argument pointed out that while the notion of closing insolvent institutions is legitimate (even desirable in a free market system, i.e., free-exit must accompany free-entry), it is still questionable whether the closure of an entire bank, forcing blameless workers to be laid-off, is the right thing to do instead of punishing only the owners and the bank's management. Out of desperation for financial support, however, the government had to give in although the number of banks to be closed was reduced to 16.

But what is more serious is that, the decision was taken at the time the country still had virtually no deposit insurance system. This is a clear example of an institution that should be ideally in place, but it wasn't when the decision to close banks was made.[6]

The resulting outcome was fully expected: after a few days of shake up, including people rushing to withdraw deposits from the bank, it soon became clear that market confidence had not been restored (the main objective of the IMF rescue plan). Instead, people were in a panic and a bank run was inevitable.

By December 1997, the economic crisis quickly turned into political crisis. Rumours of all types spread. The new budget announced in January 1998 did not satisfy the market. The stock market plunged and the rupiah hit an insane level of over Rp11, 000 per US$. Pandemonium set in when on January 8 and 9 people went on a buying spree to hoard foodstuff, resulting in soaring food prices (i.e., hyperinflation).

Following the signing of another letter of intent with the IMF in mid-January 1998, the government announced the cancellation of 150 projects, many of them involving the operations of companies controlled by Suharto's children. This angered Suharto, although he personally signed the agreement. Before long, he ordered restoration of those scrapped projects. The decision can also be seen as a sign that Indonesia's policy makers might not have expected the worst at the time. There was even a sense of over-confidence over how to

[6] Actually, such an institution should have been in place when the government liberalized the financial sector in 1983 and 1988.

handle the crisis. But the fact was it hurt the credibility of the overall policy. This explains why the initial market reaction to the reform package was negative.[7]

The policy credibility was further bruised when some owners of the closed banks protested publicly and decided to open a new bank using basically the same set of facilities. There was also confusion over the policy choice, i.e., between strengthening the rupiah and expanding the money supply. Then came the government's plan to adopt a currency board system (CBS). Several weeks were wasted considering that plan, and at the end it led to nowhere.

Following the announcement of Habibie's candidacy as a vice president, the rupiah collapsed further. The May 1998 riot (involving looting, burning, and raping), where more-than 500 people were killed, seriously disrupted the distribution channels for food and other basic commodities. Chinese merchants, having a key role in such distribution, ceased to operate.[8] The event aggravated the already serious problems of delivering goods across the many regions spread over 13,000 islands, especially when an increasing number of transport services stopped operating due to soaring prices of spare-parts.

Upon his return from a non-aligned group meeting in Egypt, Suharto tried to respond by proposing a compromise plan. After a meeting with Islamic and community leaders, he announced that he would not step down immediately, but he promised to revise political laws through a reform committee, the members of which would include representatives of the student movement. The two-month old cabinet that included his daughter, Tutut, and his closest crony, Bob Hasan, would be reshuffled immediately in order to handle better the deep economic and political crisis, and the planned increase of fuel and electricity prices would be revised. Another most important point of Suharto's announcement was that he explicitly pledged not to run in the new elections. Many analysts suspect that such a compromise scenario was the result of a negotiation process, in which the Arms Forces Commander, General Wiranto, was a key player. But the students and the public rejected the proposal.[9]

On 18 May, the wave of students' protests escalated. Thousands of them managed to enter the parliament compound, demanding an immediate special session of the People's Consultative Assembly (MPR) and Suharto's resignation.[10] Once again, investors and the market faced many

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[7] In retrospect, it was precisely the saga of that January letter of intent that made the stand off between the Indonesian government and the IMF turn grave, and consequently the crisis of confidence became serious. One perspective contends that through that package the IMF wanted to reform not only the Indonesian economy, but also Suharto's governance of the country. While noble and desirable, the move was believed to be beyond IMF's jurisdiction, and at that time the IMF was accused of only catering to the mood of the U.S Congress (i.e., they were politically motivated).

[8] When hardship was widely felt, the ethnic Chinese could easily be used as a scapegoat, as verified by the events of May 1997. This has been the pattern since the New Order government came to power. While Indonesia's first President Sukarno liked to play revolutionary nationalism to hold the country together, Suharto used an inward looking nationalism, the strength of which was drawn from the anti-Chinese sentiment.

[9] Opinions within the pro-reform groups polarised at the time: one group strongly rejected the proposed scenario, while another saw it as a sufficient starting point, given that Suharto had never before explicitly said he would not run in the elections. Followers of the first group expressed scepticism and fear that such a deal was a last shrewd political game being played out by Suharto behind the opaque screen of a Javanese shadow puppet play. They even called for mass demonstrations on 20 May, Indonesia's National Day of Awakening, to mark the anniversary of the formation of the country's nationalist movement to fight against the Dutch colonial administration in 1908.

[10] By 3:30 p.m., under massive pressure, the Speaker of the House, Harmoko, flanked by two deputy speakers, announced that the top leaders of the parliament were calling on Suharto to step down for the sake of national unity. The students cheered the announcement, but the hope quickly faded when in the evening of the same day at 8:00 p.m. the armed forces commander, General Wiranto, said that Harmoko had spoken as an individual and his call for the President's resignation had no legal power.

uncertainties. At the time, however, there was one certainty: Suharto's era was over! Only the exact time and the mode of transition that remained uncertain.

Then came the historic day, 21 May, when Suharto announced his resignation and Vice President B. J. Habibie replaced him. A surprise? Not quite so. The intensity of the pro-reform movements and the dynamics of high-intensity political struggles during the preceding few months should have been enough to predict the outcome. The nomination of Habibie was not a surprise either, since constitutionally the vice president was next in line.

The exit of money and capital, especially that owned by Indonesian Chinese (it is often quoted, albeit with no supporting hard data, that ethnic Chinese control about 70 per cent of the assets of Indonesia's top 300 companies), was also a serious blow to the economy. The exodus of expatriates and foreigners bruised the country's image and made the prospects for economic recovery gloomier. Meanwhile, the exchange rate and the stock market continued to "go south". On 18 May, the former touched 17,000 per US dollar and the latter came closer to a low of 400, whereas in the third week of April, the recorded rate and the stock index were still 8,024 and over 490, respectively.

Clearly, the Indonesian crisis was influenced not only by a set of economic factors (microeconomic and institutional) but also by political uncertainties. It is obvious that the latter significantly affected the duration and the depth of the crisis.

Devastating Social Impacts

The financial and economic crisis brought a series of far reaching repercussions on peoples' lives. What was started as a contagion that led to the collapse of local currency turns out to be nastier than what many people thought. Other factors, e.g., weather condition leading to a long drought, serious haze problems, and increased political tension, which culminated in a dramatic change of government, simply aggravated the already vulnerable economy.

Prices went up significantly since the collapse of the rupiah. The inflation rate was approaching 80% in 1998. What is more serious is the fact that the price of the food component in the CPI measure (contributes roughly 40%) rose most sharply. If the real consumption dropped as much as the rate of these price increases, the impact on poverty would be most devastating. But there was a process of consumption smoothing.[11] There was evidence that such a smoothing process also took place in non-food consumption. However, the impact on poverty, more particularly on diets, was more serious when the smoothing was in food consumption among the poor.

Meeting the targeted supply of foods (closing the gap with imports) was undoubtedly an important challenge. But to distribute food items among different groups in various regions throughout the country was a far more challenging task. Due to the rising costs of vehicle parts, estimated to increase by 400%, many public transportation facilities, including inter-island shipping, stopped operating, cutting off the mobility of millions of medium and low income workers (Azis, 1998a). All domestic airlines companies are also in deep financial difficulty. One of them, *Sempati*, was forced to close down. At any rate, these factors contributed to the soaring prices of some basic commodities.
The unemployment impact of economic contraction was equally devastating. With 14% drop

[11] Many households either changed their food menu (e.g., eating rice once a day, using other less desirable foods the rest of the time), switched to lower price food materials (e.g., from imported to domestic produce), or used their accumulated savings (dis-saving).

in GDP for 1998, the unemployment rate went up substantially.[12] The carry-over of unemployment from 1997 is estimated to be around 6 million, already higher than in 1996, and the new labour force entrants were roughly 2.6 million. Hence, even if the economy was not growing (zero growth) with no newly laid-off worker, the unemployment figure is already 8.6 million, or 9.3% of the labour force. But with higher employment elasticity and taking account the new labour force entrants, the total figure of unemployment in 1998 could reach as high as 20 million.

Obviously, variation in the sectoral elasticity matters. While most economic sectors suffered from a significant contraction, the agricultural sector managed to post a positive growth. With different sectoral employment elasticity, the estimated number of total unemployment is likely to change too. Furthermore, sectoral variation has also a gender dimension. The downturn in the construction sector likely hurt male workers more than female workers. Even within one sector, say, manufacturing, the contraction in different industries affect female and male workers differently. In the machinery sector, for instance, most affected are male workers, while downsizing in textile and electronic industries may affect disproportionately female workers.

The link between unemployment and income drop is rather complex. But some trends emerged under the current crisis situation. In the manufacturing sector, there were cases where workers were paid less to avoid being laid-off, and in other cases hours of work were reduced. In the rural sector, the increased labour surplus due to urban-rural migration was mitigated by hiring more people but at lower wages (the trend of declining real wages in the agricultural sector has been detected as early as 1997).[13]

There are also more and more skilled workers willing (or forced by the situation) to work in less desirable jobs with lower wages. These workers are part of the growing middle class in the country who enjoyed tremendous welfare improvement during the economic boom in the last decade. They seem to be the hardest hit by the crisis. They are relatively educated, very conscious about their economic aspirations, and increasingly well aware of the impact of socio-political developments on their well being.

When flexibility in the labour market is present, and hours worked are reduced, we have a situation where the total number of unemployment may not be much affected, but underemployment is on the rise, suggesting lower productivity and wages. For most workers who lose their jobs, the informal sector has become the safety valve. It remains to be seen to what extent the continued flexibility in the labour market can be tolerated. Notwithstanding, real wages dropped, and with a sharp increase in prices purchasing power collapsed

[12] Measuring the number of laid-off workers since the crisis kicked off is very difficult, especially since the economic contraction is still unfolding. A reasonable approach would be to use employment elasticity, albeit with notes that this elasticity is usually calculated from data generated during the good years (e.g., 1990-1996). Yet, international experience suggests that employment elasticity during the crisis period should be higher. If one uses employment elasticity of 0.35, the number of laid-off workers would increase by 4.6%. If, instead, an elasticity of .45 is used, the number of laid-off workers will increase by 5.9%.

[13] In time of unfavorable weather condition, rural-urban migration is a common phenomenon; whereas in time of economic crisis, urban-rural migration tends to increase. It is hard to estimate the magnitude of each movement, although some reports indicate that seasonal migration to Jakarta and other big cities has declined and the labour surplus pressures mounted in many rural areas. One thing is clear, however: in both urban and rural areas wages have declined.

When prices move north, especially those of food and other basic commodities, and income goes south, it is expected that people's buying power and consumption drop, causing the incidence of poverty increase. Like the unemployment rate, the poverty incidence represented by the head count index in the post-crisis period is hard to measure.[14]

Depending on the assumptions of growth and patterns of household consumption during 1995-1998, the estimated head count index could range from less-than 50 to over 79 million; both numbers are way above the "bottom" level in 1996, which was only slightly over 20 million.

The sensitivity of the poverty figure is particularly high in Indonesia, since there are a large number of households with expenditures just around, or slightly above, the poverty line. It only needs approximately a 20% increase in the poverty line to double the number of population living in poverty.

From my study using a structural path analysis (SPA) and price-endogenous computable general equilibrium (CGE) models, it was revealed that the damage in the real sector had ripple effects on the services sector, reducing the demand for workers of the professional rural and urban category, the growing middle class of the country (Azis, 1998a). In turn, the overall income of most urban household declined. The large drop of employment in rural professionals suggests that the rural non-farm activities are likely to receive a recession contagion from the urban-based economy. This also implies that there is no alternative outlet in the rural areas for the urban middle class who lose their jobs. Very likely, some of them will end up working in the informal sector.

The same study also suggests that wages have declined, especially in the urban areas. The per-capita consumption of all urban workers dropped, the largest decline of which was for the urban medium type. In general, therefore, the relative position of the urban sector deteriorated more than that in the rural area. If the above trend continues, the number of poor in urban areas could be comparable with that in the rural (for comparison, in 1996 the number of urban poor was only 20% of the rural poor). Hence, the country has to be prepared to face a massive increase in urban poverty, a fertile ground for internal conflicts and social discontent.

With the deteriorating economy, the list of adverse social impacts can easily get longer. In formulating domestic policies, a number of basic principles should not be relinquished. Simple populist approaches, though easy to formulate, would not help. On the contrary, they could hinder the process of real recovery by distorting consumption and production.

Community-based public works programs are likely to be ineffective if wages to be paid are higher than the prevailing wage for the unskilled labours. The failure of most social safety net (SSN) programs shows that the design of the program was poor and so was the implementation.

[14] Following the cost of basic need (CBN) approach and by using 1995 as the benchmark year, one can generate the following numbers. The average costs of basic foods are: Rp.20,403 (Rural) and Rp.25,998 (Urban). Changes in food prices from January 1995 to June 1998 would be 213.7% (R) and 229.4% (U). With the Engel ratio of 0.801(R) and 0.770(U), the estimated poverty lines per-capita/month are: Rp54,433.2 and Rp77,445.0 for rural and urban areas, respectively.

D. Institutions and Policy Evaluation in Retrospect

Weak Institutions Fused With Rapid Economic Opening and Massive Capital Flows
Since the mid 1980s, through a series of pro-market reforms the Indonesian economy has become much more open. Liberalisation was pursued in the trade, investment, financial and banking sectors. As far as the capital account is concerned, Indonesia was one of the very few countries in the world that had already adopted an open capital account system even before (long before) the pro-market reform in 1980s.

The resulting outcome of the strategy was impressive: double-digit export growth, strong GDP and investment growth, single-digit inflation, and fairly manageable current account deficits. But behind all those statistics, various institutions, formal and informal, remained weak, stagnant, and socially inefficient. Hence, the overall performance is probably best described as the reflection of a sound macroeconomic policy but with severe institutional constraints. Let me explore further the issues of institutional constraints.

Institutional change is a process that takes place as a consequence of changes in at least three factors: (1) formal rules, laws, regulation, and other legal systems, (2) informal constraints embodied in norms, customs, traditions, and codes of conduct, and (3) effectiveness of enforcement of those two factors.

The Indonesian legal system was marred with flaws. In almost all affairs effective checks-and-balances were absent. Even the formally installed rules, regulations, and laws, were not effective, and weakly enforced in almost all sectors and levels of organisation.[15] More often than not, most effectual decisions, be it in political, economic, or business affairs, were only optimal privately (to one's own benefit), not socially in Coase sense (Coase, 1960).

Informal institutions and the prevailing social norms also sufffered from the same predicament. When a very high profile political or business case was at stake, the ultimate decision generally must have come from the very top person. Often, that would mean from Suharto himself or from his inner circle. In this sense, he was practically the only--most effective--institution in the country.

The Indonesian Army, another important national institution, had been loyal to Suharto. When the economy was booming, the military gradually transformed itself from a repressive force into a mechanism to share some of the national wealth. When the country was awash in cash, money was the mechanism for national solidarity. Holding most of the wealth were Suharto and his children and cronies. This, once again points to Suharto being the only effective institution.

It was no secret that a large chunk of business undertakings had fallen under the domination of either members of Suharto's family or his cronies, leaving control over only a small portion of business activities to be competed.[16] Even some foreign investors and external partners in joint-ventures that operate in Indonesia tend to comply with such a socially non-optimal

[15] Even in the agricultural sector, the fact that there was no clear land ownership or land security also reflects an institutional flaw in the system.
[16] It is reported that the share of top 10 families in total market capitalization in Indonesia in 1996 was close to 58 percent (a World Bank study by Claessens, et al., 1999).

norm. In looking for domestic partners, they would prefer to venture with those who have close political connection.[17]

As expected, when Suharto is no longer in power, the stock values of these politically sensitive companies are the first to drop sharply. Investors and foreign partners are turning their back on them. Companies owned by the children of Suharto or by businessmen deemed to be close to the former leader have been most affected and are still likely to get worse if there is any change of government as a result of the upcoming election.

One of the most fiercely debated policies that is suspected to have spurred the recent banking collapse is the 1988 bank reform, through which opening up a new bank was made much easier than before. While allowing robust investment and economic growth, the fast growing number of banks since then had produced considerable side effects. Many big companies (conglomerates) set up banks or multi-finance institutions primarily to serve their own projects. Such a practice does not put such ventures into a category of shareholder (equity market) system nor a universal banking governance style.[18]

Despite the standard regulatory measures formally imposed by the monetary authorities (e.g., legal lending limits, capital adequacy ratios and so forth), weak enforcement discouraged the development of a healthy banking sector. Indeed, when a contagion-led crisis strikes, the weaknesses of the entire financial sector become more prominently revealed.

Government's favouritism was also widespread. Under the 'privatisation' flag, well-connected private sectors with high leverage were selectively granted financial assistance (loans) through the state banks with lower-than-market interest rates and enjoyed more lucrative conditions. In some cases, the probability of default was high. Even when funded projects proved profitable, debt repayment could be slow and arduous, aggravating the problems already faced by the state banks. The resulting irony is, privatisation increases--not decreases--the public burden.

There was a perception among policy makers and the business community that large business enterprises or conglomerates, whether state or private owned, are essential if the country is to catch up with modern technology and compete internationally. It is not surprising, therefore, that many large business enterprises, including those owned by Indonesian families of Chinese descent, owe their size to government favours, including preferential access to government contracts and licenses. This perception and the resulting conduct persisted despite the fact there is little evidence that large enterprises are particularly efficient.[19]

[17] Some foreign partners, however, resisted the improper norms. For example, in considering buying a stake in a failing petrochemical center Chandra Asri owned by Bimantara group, a loose amalgam of more than 150 companies controlled by one of Suharto's sons, Dow Chemicals was asked to pay handsomely for a piece of action in the process (high transaction cost but not internalized). Probably realizing the risk involved, Dow chose not to invest. IBM is another company known to be strict in repulsing improper deals with the Indonesian partner.

[18] It has been known that most major companies, especially the conglomerates, are still of a family-based type, evolving from a system of own family financing, internal resource funding (including funding from family groups based on the family and kinship networks that exist especially among Chinese business people) to a more bank-funded system. The equity-market-based operation is still in its infancy. Security markets have not yet been dominant, since they require a more sophisticated institutional and regulatory framework. However, since the funding institutions are the bank set up by the company itself, the financing for corporate expansion and diversification is basically still "internal." In this sense the corporate finance markets are hardly of a Japanese or a German type of universal banking system.

[19] At the same time, it also led to another perception that economic liberalization started in the 1980s has

The central bank had some roles to play as well. It was increasingly more willing to bail out troubled banks, typically those with well-connected owners. The stated goal is seemingly clear: to avoid defaults and bankruptcy. But the fact is, avoiding default now will actually increase the probability of future default. Furthermore, when the exchange rate dropped to below 7000 rupiah per US dollar, practically all banks became insolvent. Only through the central bank's life support system (special direct credit known as *Kredit Likuiditas Bank Indonesia* or KLBI) the banks remain in operation. The problem is, as the country's banking condition got worse, suffering from a significant negative spread, the ability (and willingness) of the receiving banks to repay KLBI is questionable.

It has been widely recognized that the country needs many improvements in the bank regulatory and supervisory framework, including loan classification, capital adequacy requirements, foreign exchange exposure limits, and other standard provisions. Those improvements have actually been taking place since the early 1990s. But the process was very slow. Yet, it would be difficult to deal with the banks' stock problems (balance sheets), without addressing the flow problems.

The above institutional weaknesses failed to cope with massive flows of capital, especially short-term capital, that have the tendency to oscillate between waves of euphoria and waves of panic. The created instability was further exacerbated by the country's quasi fixed exchange rates system. The pressing question is therefore: if the country's institutional factors were weak, how come the economy grew so strongly and did so for more than a decade?

First of all, as indicated earlier, social norms or informal institutions were not conducive to a fair play. The business environment during the boom period was strongly based on power (political) connections, personal relations and tolerance. The broader and more popular term is *CCN*, stands for Corruption, Cronyism and Nepotism. Firms or business entities do not follow what is known as a complete (formal) contract system, implying that not all contingencies are covered by contracts such that some decisions are made informally by owners, e.g., family and kinship networks, acting as the residual rights holder. Out of such decisions, quasi rents were appropriated and in some cases transaction costs could be kept low because it was not internalized.[20]

When the economy and the business sector flourished, there was no strong need to alter the system. As long as growth was delivering benefits to practically everyone, *CCN* could be tolerated as annoying but not fatal. Consequently, the demand for improved institutions was not there.

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favored the Chinese business groups, since the rise of Chinese conglomerates occurred at the same time as deregulation and liberalization policies were undertaken.

[20] Ex-post bargaining over the quasi rents generated in an enterprise is an important part for understanding the definition of a governance system. Meanwhile, the notion of transaction cost can be described as follows: as supposed to transformation costs, i.e., to transform the physical attributes of a good (size, weight, color, location, chemical composition, and so forth), a transaction cost is a cost for defining, protecting, and enforcing the property rights to goods that provides the right to use, to derive income from the use of, to exclude, and to exchange (North, 1990). Unlike in a neo-classical world of no transaction cost, in the real world the two costs should form the total costs of production. But often in developing countries the transaction cost is not included in the system (externalized). The externalization of transaction cost is more likely when the contingencies are not covered by the contract (informal) or when enforcing the formal contract is not seen as too important, hence entailing a seemingly low cost.

There is another explanation. The government's direct and indirect involvement was heavy in almost all economic activities. In the agricultural sector, for example, the green revolution, physical, chemical and biological based, would not have achieved its desired goal without enormous subsidies and credits from the government.[21] This led to the success of Indonesia in, among other things, achieving rice self-sufficiency, a status that no longer dwelled even before the crisis erupted.

In the more liberalised manufacturing sector, government influence was also pervasive even after the major reform in the 1980s. Within a privatization scheme, the decision on how the process should operate, and to whom the entity is to be sold was either not made transparent or rested eventually on the government's decision. In the process, the practice of CCN became widespread.[22] In effect, even in the absence of a fair and transparent institution the process of privatization actually took place (hence was effective), allowing more resources to be tapped, and was capable of generating higher output growth.

Although less recognized, a competitive market is a necessary requirement for a successful privitazation program. Yet, impediments to competition abound. Formal and informal restrictive marketing arrangements favoring families and cronies could be found in many industries and activities (from cloves to the automotive sector). Furthermore, the government often interfered with business practices, e.g., bankruptcy and bidding procedures, mergers and acquisitions. In the process, CCN persisted.

To make matters worse, a considerable number of corporate sectors had not adopted accounting standards in line with internationally accepted practices. Mark up pricing, unrealized receivables and other improper forms of book-keeping were not uncommon. Consequently, profits would look higher and debt-equity ratios tended to look artifically smaller.

Another important source supporting the robust economic performance was the massive capital inflows. Thanks to widespread optimism over the region's future growth and the celebrated label of *"East Asian Miracle,"* domestic and foreign private investors were poised to expand their activities ever since early 1990s.[23] The high domestic interest rate did not dampen their enthusiasm, largely because foreign loans were easily obtained at a relatively low rate. The label "miracle" also seems to have swayed lenders and the international financial community to the extent that they recklessly made many high-risk loans.[24]

At any rate, even with many institutional deficiencies Indonesia could still manage to produce a "successful" growth story. But when perturbed with a shock, i.e., contagion from Thailand during the summer of 1997, the story ended; the system was bound to disintegrate. It was

[21] The government was particularly active in disseminating new agricultural technologies, especially in the smallholder foodcrop sector, and for improving access to education and public health (Booth, 1994).
[22] The annual Global Competitiveness Report (GCR) in 1998 reported that Indonesia is among the countries that score a low rank (34th) in quality of governmental institutions.
[23] The following (pre-crisis) statistics indicate the attractiveness to invest in Indonesia. During 1988-1996, the median of return to assets (RoA) and of year-on-year real sales growth of Indonesian firms are recorded to be 7.1 and 10.6 percent, respectively. These figures are much higher than those for other countries.
[24] The trend of total private borrowing was quite alarming. According to Bank for International Settlements (BIS), a year before the crisis the total private debt in Indonesia, excluding offshore bonds and commercial papers, reached US$55.52 billion, or 25 percent of GDP. Out of that number, US$34.24 billion (or 15.4 percent of GDP) fall under the category of short-term, with maturity less-than one year. Unlike in Korea, most of these private debts were made in the corporate sector (literally hundreds of them).

unsustainable. As soon as the effort to sustain an impressive growth demanded unflagging supports from proper institutional factors with postive (high) transaction cost, a serious mismatch was unveiled.[25]

Evaluating the Policy Response and the Myth of Credit Crunch

The appropriateness of the IMF policy has been often questioned. The primary objective of the IMF policy was to restore market confidence. This was done in two modes. First, by restricting the aggregate demand through raising the interest rate and curtailing the budget. The second mode, usually considered not really within the IMF jurisdiction, was to improve the real sector's efficiency by removing monopoly (including closing non well-performing banks).

But following the implementation of the IMF policies, confidence on the Indonesian financial market did not improve. On the contrary, as already discussed earlier, the closure of 16 banks resulted in a bank run and created a panic. Furthermore, it had become clearer that the debt overhang was far more serious than originally thought. As long as this debt problem is unresolved, the country has no choice but continue to succumb to currency pressures. Yet, the IMF did not initiate any strategy along this line. Instead, they firmly insisted on using interest rate to strengthen the rupiah.

Evaluating the correlation between interest rate and exchange rate for 4 quarters since the onset of the crisis, and by using rolling regressions (daily data are used), a significant correlation is found for three periods: June-September 1997, July-October 1997, and August-November 1997. But what is striking is that, the signs of the coefficients do not support the standard hypothesis (that raising interest rate will strengthen the currency); they indicate the opposite direction! Even during the period that followed, i.e., after the IMF began its rescue operation in October 1997, still no significant correlation is detected.[26]

In an exercise using microeconomic (firms) data, I tried to measure the Indonesian firms' exposures to foreign exchange and interest rates. From the calculation, I found that the (collapse of) firms' stock returns are generally more affected by (high) interest rate rather than by the (depreciated) exchange rate. The conclusion also applies even to firms with large un-hedged foreign debt exposures. In other words, raising the interest rate would create a devastating impact on many firms' balance sheet, more so than letting the rupiah to depreciate.[27]

A more common argument against raising the interest rate is that, a soaring rate may cause a credit crunch. On this subject, it is interesting to note that the increased interest rate in Indonesia did not seem to result in a contraction of money supply. Even the growth of credits allocated by the commercial banks was not slowing down after the crisis (it increased by as much as 15% during 1997-1998). The real money growth also grew significantly. So, where is the credit crunch?

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[25] Putting it differently, treating the transaction cost as if it is zero while the fact is not, that would suggest that either institutions do not adjust efficiently or they are stagnant.

[26] When the calculation is applied for the entire period from June 1997 to April 1998, the resulting coefficients are insignificant, but the signs indicate a rejection to the standard hypothesis. Similar findings are obtained for Malaysia, Philippines, Korea and Thailand.

[27] A similar study using Thailand data, for 29 sectoral categories also came to the same conclusion. See Bhaopichitr (1999).

There are at least two explanations to the unexpected trend. First of all, in an effort to improve their balance sheet, banks' claims have to be raised. But with stellar interest rate, no investor is willing to borrow money. However, during the last several months Indonesian banks suffered from a negative spread; in some cases the spread can be as much as (minus) 20%. Hence, many individuals (non-investors) took the advantage by borrowing money and depositing the borrowed money back in the bank with a higher rate of interest.

Secondly, many companies need to restructure. In some cases, they need to pay an enormous amount of debts. It is through such a passage some banks continued to extend credits, even when the interest rate was high and they suffered from a negative spread. Virtually no extended credit was used for investment. Such a claim is supported by the data from the national income account that show real investment dropped by as much as 40% in 1998.

What makes banks survive with a negative spread? Most banks re-deposited their funds in the central bank's certificates (SBI or *Sertifikat Bank Indonesia*). These certificates offered a slightly higher rate of interest than banks' deposit rate. Obviously, this condition can not be sustained, but until the bank and corporate restructuring is in full swing, most of them will have to operate through such a mode.

What about budget policy? At the beginning, the IMF also imposed a tight budget. While the economy was already in dire situation, the planned budget was forced to generate surplus. Many expenditure items had to be slashed, the most controversial one of which was the removal of fuel subsidy. Consequently, prices soared.

But when soared prices fused with a deteriorating political situation, tensions flared. The repercussions were devastating, i.e., exodus of capital, ethnic conflict, and a broken-down system of distribution. Only when the social repercussions became more serious (discussed in the preceding section) the IMF position on the budget softened, allowing the government to plan for a deficit budget (as high as 8% of GDP).

The IMF's insistence on the medicine seems to be based on their "success" in rescuing Mexico from the 1994 crisis. If it worked in Mexico, it should also work in another country. Unfortunately, there is a big distinction. The Japanese economy has been in shamble for the last few years. To many Asian countries, including Indonesia, Japan is like the U.S to Mexico when the latter recovered relatively quickly by getting a strong boost from the U.S economy. Obviously, with Japan still in recession such a boost is absent in Asia.

E. Post-Suharto Conditions

Habibie's government had to inherit some unfavourable conditions, including negative sentiment of the market towards Indonesia and political damages caused by the misdeeds of his predecessor. He certainly has no shortage of challenges. Even without the financial crisis, the country has been stricken by a long drought (related to the El Niño phenomenon), the haze problem caused by major forest fires, a fall in oil prices, and a series of diseases that occurred in some parts of the country. The financial and political crisis only exacerbated the situation.[28]

The remaining strengths of the country -- the enormous amount of natural resources, fairly adequate physical and non-physical infrastructure, and, more importantly, the cohesiveness and

[28] The economy had already started to slide in mid-1997, and the worst really began early in 1998.

the harmony within a heterogeneous Indonesian society -- may now be under threat. A cry for a greater share of resources and autonomy in the outer islands is also ringing loudly. Many regions in the outer islands, especially those that are rich in natural resources (e.g., Aceh, Irian Jaya, Riau, East Kalimantan) feel that they have not been treated fairly by the Jakarta bureaucracy. For two decades, the government did not let the long awaited laws on central-regional fiscal relations pass the parliament. There is also widespread distrust towards public officials who have been appointed by Jakarta rather than being elected to their positions.[29]

On the positive side, Habibie's government has overseen a real liberalising of the political system, although some argue that he simply did not have a choice to do otherwise. In the new election laws, parties and candidates are allowed to campaign without serious restrictions, the presidency is limited to two terms, and the armed forces are stepping away from politics. Some political prisoners have been released, and the press is definitely freer.

As far as economic affairs are concerned, the policy direction has been on the right track, i.e., restructuring the banking and corporate sector, improving the social safety net programs, and maintaining macroeconomic stability. Except for the details of implementation, these are non-disputable programs. [30] The only debatable issue, perhaps, pertains to the unnecessary persistence of the government and the IMF to keep interest rates high for so long despite the fact that there was no supporting evidence indicating a significant correlation between higher interest rates and stronger exchange rates.[31]

Bank restructuring includes the setting up of IBRA (the *Indonesian Bank Restructuring Agency*) and a massive re-capitalization program involving at least 300 trillion rupiah.[32] In the process, IBRA will have to do a lot of stripping of assets that it seized. The timing is tricky, yet important. It has to be fast enough to send a positive signal to the market (the longer the seized assets are held, the worse they will be managed), but not too fast to miss the recovery prices. Many of these banks' assets are associated with companies that enjoyed lucrative government contracts in the past due to their close connection with Suharto's inner circle.

[29] Incidentally, this can create an interesting dynamics in the political calculations. First of all, many regions in the outer islands are not only unscathed by the crisis, but some agro-based exporting area have even benefited by the depreciated exchange rate. This is a stark contrast with the conditions in Jawa, where the demand for total reform ('reformasi total') has been shouted most noisily. Hence, there is a potential gap in perceptions of political renewal between those who rule in Jawa and those who live under the rule of Jawa. Secondly, there is a possibility that in the upcoming election the country's political balance could shift in favor of the outer islands. It is no coincidence that the current bet is that Golkar, the ruling party, will win in most regions outside Jawa (President Habibie, born in Sulawesi, is regarded as a hero in his home province).

[30] Most local economists are in agreement with the general direction of the policy. They even emphasized the need for government to implement the programs consistently. A group of respectable economists from major universities was engaged in a series of events throughout the country aimed at "educating" the public about the nature and importance of the programs.

[31] Interestingly, it was shown in one of the IMF studies that the coefficient for the whole sample was not significant, but the selected choice of sentence is: ".....there is no clear evidence that higher interest rates led to weaker exchange rates." (Goldfajn & Baig, 1998, p24-25).

[32] By summer 1998, IBRA already placed 54 banks under its control, took over the management of 8 banks, including Indonesia's largest private bank, Bank Central Asia (later nationalized), and three other banks, Danamon, Bank PDFCI, and Bank Tiara, and suspended the operation of three other banks. The last seven banks had received massive liquidity support (more than 500 percent of their capital, or more than US$11 billion) from the central bank through IBRA, in order to keep their operations going. If one of these banks was the creditor of a bad debt, IBRA will take charge of the negotiation with the debtors. On deposit issues, all commercial banks liabilities will be guaranteed by IBRA.

It is no secret that in the process, tensions have been high and various intimidations are directed to IBRA officials. Some pressed for indulgence; others wanted to use the opportunity to boost asset re-distribution favoring indigenous medium and small-scale enterprises.

In general, the banking reform is aimed at assisting viable banks in restructuring their capital, settling the problems of non-viable private banks seized by IBRA, settling the merger process of state banks, and strengthening the banking supervision system. In May 1999, the whole undertaking got a boost from the decision by international banks to swap more than 3.2 billion US dollar in external debt made by Indonesian banks, for longer-term sovereign debt.

Corporate debt restructuring was executed through INDRA (*Indonesian Debt Restructuring Agency*), complemented by what is known as the *Jakarta initiatives*.[33] Foreign debt included in the INDRA scheme will have an 8-year life span. For the first three years, INDRA will pay only the interest payment. The principal and the interest will be paid during the remaining five years.[34] In order to help restructure the corporate sector, the government plans to issue global bonds backed by a guarantee from Japan.[35]

The World Bank, ADB and the IMF have provided financial and technical support for the two restructuring programs. The World Bank and ADB also help support the controversial social safety net program, while the standard macroeconomic policy was "coordinated" by the IMF. This leaves only a small space left for a truly domestically designed economic policy.

The implementation of social safety net programs is marred with leakage and low absorption, yet they are critically needed given the extent of the devastating social repercussions of the crisis. Across sectors, real wages had declined, especially in the urban areas, and the per-capita consumption of all urban workers dropped, the largest decline of which was for the urban medium type. The impression that the poor were hit the hardest is quite misplaced. Nonetheless, poverty incidence increased (Azis, 1998a).

In general, the relative position of the urban sector deteriorated more than that in the rural area. If the trend continues, the number of poor in urban areas could be comparable to that in the rural areas (in 1996, the number of urban poor was still only 20% of the rural poor), suggesting that the country has to be prepared to face a massive increase in urban poverty, a fertile ground for internal conflicts and social discontent.

Such a development, combined with the fact that the predominant factor in Indonesia at this moment is political in nature, could not help prudent macroeconomic and restructuring

[33] Debtors participating in INDRA make installments in rupiah, which in effect is similar to purchasing US dollar in an amount equal to the principal amount of their restructured debt at a pre-announced exchange rate (e.g., on August 19, 1998, the rate was 13,233 per US dollar). Such an installment is made on a monthly basis over the life span of the debt, or over a period ending December 31, 2003. The dollars purchased are then relent to INDRA, which will make the installment of principal and interest payment in US dollar to the creditors on a quarterly basis, at an interest rate equal to the three-month LIBOR plus a margin not to exceed 3 percent per annum.

[34] Based on the official document, INDRA can not deal with domestic debt in foreign currency, the amount of which is estimated to be more than US$30 billion. A considerable amount of this debt will be written-off. Already, the Indonesian supreme court suggested that the economic crisis could be considered "force majeure" (beyond the control of parties involved in the contract). The new bankruptcy law, which allows debtors to have the option to seek bankruptcy protection for 270 days, can also help declare debtors bankrupt.

[35] In the latest GOI-IMF letter of intent, it was stipulated that the bond issuance would be carried out in two stages. On May 28, a fixed rate will be offered, and on June 30 a more market-determined rate (SBI 3-mo rate) is to be used.

policies to easily restore market confidence. In the recent past, communal conflicts have erupted, involving Indonesian Chinese, Christians, animists, and Muslims. The armed forces, which have traditionally held the archipelago together, are now constrained by their tarnished standing due to their past misconduct.

With such a rampant political pluralism, even undisputable economic policies failed to produce the expected outcomes. The exchange rate and the stock market continued to collapse until the last quarter of 1998, and the economy contracted most sharply in that quarter.[36] When in November 1998 the rupiah strengthened to the 7,000-8,000 level, there was a ray of hopes. But it was shortlived. A series of conflicts and incident, rising crime rate and deteriorating public safety continued to erode investors' confidence.

Then a more significant hope came in the second week of May 1999, when the 7,000-8,000 level was once again reached. The newly released data of output and inflation for the first quarter of 1999 also provide a sign of improvement. The GDP posted positive growth (1.34 percent), mostly driven by increased personal consumption (1.4%), and for the second consecutive month the consumer's price index dropped, i.e., deflation of around 0.2 and 0.7 percent in March and April, respectively (the annualized rate is only over 10%, compared to 77% in 1998). If the trend continues, interest rates will gradually decline, allowing the equity market to rebound.

Has the economy bottomed out? Is there finally a light at the end of the tunnel? Interestingly enough, such a new optimism comes just a few weeks before the parliamentary election takes place (June 7). Most analysts contend that the timing and speed of economic recovery will depend on the country's ability to get its political house in order. The June election, expected to be the first truly democratic one since 1950, is a first test. Judging from the exchange rate trend, an unfettered optimism is too premature.[37]

Actually, the risks at this moment hinge not only upon the conduct of the two upcoming elections, but also on the extent to which the (current and new) governments are able to maintain the momentum of reform and restructuring in the banking and corporate sectors, and not put the tasks in cold storage just because the recently revealed data may have created a new sense of optimism.

On the issues of institutions and governance, it is generally agreed that policies to make improvements are not short-term oriented, but they ought to be started soon.[38] Efforts in this direction are currently being intensified. A considerable portion of external money is

[36] The country's banking sector was among the most badly damaged. Until the last several months, Indonesian banks suffered from a negative spread; in some cases the spread can be as much as (minus) 20%. Many individuals (non-investors) took advantage of this by borrowing money and depositing the borrowed money back in the bank with a higher rate of interest. In the restructuring process, many companies need to pay an enormous amount of debt, partly paid through bank credits, inspite of the high interest rate and persistent negative spread. Virtually no extended credit was used for investment (in 1998 real investment dropped by as much as 40%). Many banks can survive the negative spread by re-depositing their funds in the central bank's certificates (SBI or Sertifikat Bank Indonesia). These certificates offered a slightly higher rate of interest than the banks' deposit rate. Obviously, this condition can not be sustained. But until the bank and corporate restructuring is in full swing, most of them will have to operate through such a mode.

[37] During the last week of May, the rupiah weakened to reach over 8,000 level again.

[38] See also a statement from the World Bank-sponsored conference in Bangkok (early April 1999) on "Asian Corporate Recovery-Corporate Governance and Government Policy," which was based on a survey of 4,000 firms from Indonesia, South Korea, Malaysia, the Philippines and Thailand between November 1998 and February 1999.

appropriated to such a purpose. International organisations, including the World Bank, shifted their priority approach to the development of effective and socially efficient institutions, with a stronger partnership between government, official agencies, the private sector and civil society in general. [39]

At the end of the day, however, it is the enforcement of those institutions that will matter most. Cases whereby laws and the court system are ineffective still abound. For example, having realized the vital role of commercial courts in the working of a market economy, a system of commercial court was set up in September 1998, along with a new set of related laws. However, without an overhaul in the entire legal structure the implementation of such laws is unlikely to be able to help bankers deal with scores of financially strapped companies that are not paying their debts.[40]

Recent instances confirm such skepticism. After the Commercial Court accepted claims by customers over money they paid to a property developer, PT *Modernland Realty Ltd*, who stopped building an apartment block, the Supreme Court revoked the decision by arguing that the bankruptcy law should apply only to loans. Another case ocurred when a conglomerate, PT *Ometraco Corp* and its subsidiary, was brought to court by a group of banks, including American Express Bank. Two separate bankruptcy petitions were filed. But the court rejected the petitions on the ground that the bankcruptcy law requires petitions for the bankcruptcy of a holding company and its subsidiary must be filed in one and the same document.[41]

F. Closing Remarks

The most important lesson to be learned from the Asian crisis, particularly the one in Indonesia discussed in this paper, is that, there is a clear need to improve and reform various domestic institutions, and to install the institutional prerequisites for reliably functioning markets.

In a sensitivity analysis I recently conducted, it is revealed that even with all the suspected factors taken into account (e.g., unregulated short-term capital flows and the country's inability to keep up with the fast growing technology), the crisis can be averted had the country's institutional factors been strong (the adopted model is based on *"Analytic Hierarchy Process"* within a cost-benefit framework).

Increased foreign ownership, as a result of corporate and bank restructuring, should not be prevented, since it can help reduce the risks of corporate sector and (systemic) banking collapse, and to generate demonstration effects regarding efficient operations and prudent risk management.

But even if all those points are already in place, there is no guarantee that crisis will not occur in the future. Crisis can occur in different times at different places, with or without being

[39] Views expressed by the World Bank's new Country Director, Mark Baird, in recent interviews with the Jakarta Post. See also a World Bank discussion draft, "A Proposal for Comprehensive Development Framework," sent by the Bank's president, James Wolfensohn, to the board, management, and staff of the World Bank Group, January 21, 1999.

[40] According to a study commissioned by the World Bank in 1997, Indonesians in general had little faith in their court system.

[41] There were of course successful cases, albeit very few. For example, a Supreme Court panel recently declared PT Dharmala Agrifood bankrupt after it had defaulted on interest payments to the World Bank's IFC and other creditors.

detected in advance. Financial volatility itself is actually not a bad thing; it is part of how financial markets operate. The most each country can do is to minimise its vulnerability to a contagion and other unexpected shocks created by volatility of short-term capital flows.

One of the ideas currently under consideration in some countries is the imposition of some sorts of capital controls. On this subject, it is important to distinguish controls on short-term capital inflows and those on capital outflows. The latter should almost always be avoided, since they tend to undermine government credibility and induce irresponsible policies.

To resolve serious debt overhang, the options of creditor-debtor bargains to stretch out loans, conversion of debts to equity, and occasional permanent write down of claims (to make debt relief an integral component of rescue packages) should not be dismissed. The act of bailing in international private investors is necessary. It must be insisted that private creditors and investors should bear some burdens in renegotiating the timing and repayment terms on existing debts when a financial crisis emerges (this point was already made in the recent World Bank-IMF meeting). Without it, they would essentially be getting a guarantee that governments and international organisations would bail them out of unprofitable positions.

I am also of the opinion that reforms of international organisations and international financial architecture are needed. As far as issues related to the IMF's role are concerned, the setting up of an IMF External Review Commission is necessary. Outside parties and professional opinions from beyond the IMF staff should be allowed to submit evidence to the the IMF Board.

The monopoly position of the IMF as the sole international arbiter of monetary affairs can be positively complemented with regional monetary bodies that can provide mutual support in the event of a financial crisis hitting one or another member country. In this respect, the exploration of "Asian Funds" should not be discouraged.[42]

Developing countries that constitute 85% of the world's population and who often bear the burden of failed IMF strategies, should be given greater voting rights (representation). Attempts have to be made to allow much wider membership of developing countries in the Bank for International Settlements (BIS).

On the outlook of the Indonesian situation, holding the archipelago together and removing the practice of CCN are among the most serious challanges to be faced by the upcoming government. Another important political challenge is related to the question of how the winning parties will split the votes and then form a coalition. Making the resulting coalition effective is a truly formidable task.

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[42] Central bankers in Asia Pacific region had once thought of setting up an agreement in which central banks in some countries would lend their foreign reserves to member countries in crisis using some agreed interest rate but with no other strings attached. In a latter stage, the Japanese vice finance minister, Eisuke Sakakibara, floated the idea of forming an "Asian Monetary Fund," (AMF) involving some US$100 billion reserves. When first proposed in the annual meetings of the IMF and the World Bank in Hongkong last year, for fear of loosening economic supremacy the US flatly rejected the idea. When it was dismissed again in the central bankers' meeting in Manila, the proposal came to an end. The basic obstacle has been always the question of money. Who would put up the lion's share of US$100 billion? But recently, supported among others by the ADB (upon pressures for the regional bank to focus on long-term development task), the idea of AMF seems to be re-floated.