Annexes

ANNEX

Indonesia

Introduction

This annex presents the detailed assessment of the role of the IMF in Indonesia's capital account crisis of 1997–98, which forms the basis for the analysis in the main report. It covers the role of the IMF in the precrisis surveillance phase and the crisis management phase. Issues related to the ongoing program with Indonesia, which began in February 2000, are outside the scope of our enquiry.

The Indonesian crisis was particularly severe and prolonged, compared with the other crisis cases reviewed in this report. GDP fell by 13 percent in 1998 and there was a substantial increase in the percentage of the population in poverty. Subsequent recovery was slow, with an average annual growth rate of just above 3 percent from 1999 through 2002, so that at the end of 2002, GDP remained about 2 percent below the 1997 level. It is useful to recall that the crisis, which largely started out as economic, became increasingly political. Particularly, between December 1997 and the spring of 1998, while it was apparent that the first program had failed, political issues related to the succession of President Suharto and growing social unrest made it difficult to design a credible alternative. Our evaluation suggests that the exceptional severity of the Indonesian crisis is in large part a reflection of the confluence of economic and political crises, which limited the ability of conventional policy tools to address economic problems.

This annex is organized as follows. It first evaluates the effectiveness of surveillance prior to the crisis. It then discusses issues of program design, including (1) fiscal policy, (2) interest rate policy and monetary targets, (3) exchange rate policy and capital controls, (4) official financing, (5) bank closure and restructuring, (6) deregulation, (7) corporate debt restructuring, and (8) the initial strategy and its adaptation. The following section discusses the IMF's mode of operations, covering such issues as country ownership, the decision-making process, human resource management, and the role of major shareholders and collaboration with the World Bank and the ADB. The final section presents conclusions and an overall assessment.

Precrisis Surveillance

This section discusses the effectiveness of IMF surveillance in three areas of potential vulnerability: macroeconomic performance, banking sector weaknesses, and corruption and cronyism. The IMF broadly identified the potential vulnerabilities in all these areas, but it failed adequately to recognize their seriousness and adverse implications.[1]

Macroeconomic performance

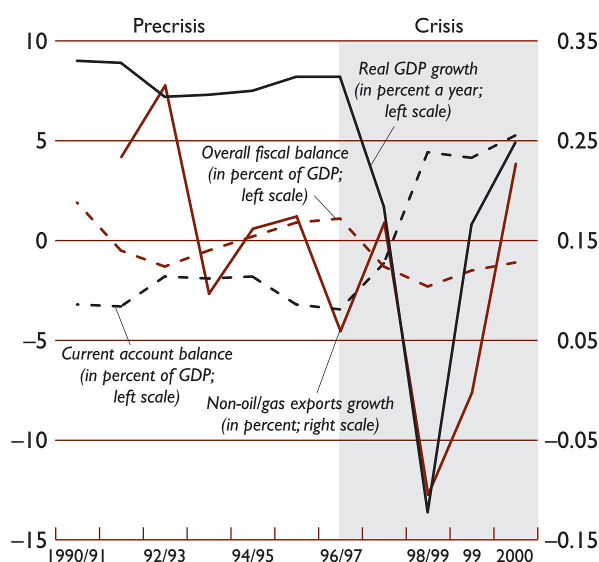
Indonesia's performance before the 1997 crisis was characterized by strong economic growth and apparently sound macroeconomic fundamentals (Figure A1.1). IMF surveillance, however, noted the risks associated with the large capital inflows, which averaged 6 percent of GDP during 1992–96. As a result, the stock of private foreign debt increased rapidly from about US$38 billion in 1995 to US$65 billion just before the crisis and US$82 billion at the end of 1997. Moreover, short-term private foreign debt was a large proportion of the total, reaching US$33 billion, just before the crisis in 1997, equivalent to 1.5 times the stock of gross international reserves. However, IMF surveillance grossly underestimated the magnitude of short-term debt, hence the vulnerability of capital flows to a shift in market sentiment.[2]

Both the IMF and the Indonesian authorities recognized that the volume of capital inflows was uncomfortably large. This was a frequent subject of discussion at official meetings (e.g., the EMEAP Central Bank Governors' meeting in early 1995) and in the academic literature (Radelet, 1995). As a counterpart of the increasing capital inflows, the

[1]At a meeting of the Indonesia Consultative Group held in Tokyo on July 16–17, 1997 for example, the IMF representative stated that "financial market confidence in Indonesia [remained] strong," while noting the "need to guard against changes in market sentiment, weaknesses in the banking system, relatively high external debt and increased financial market turbulence in the region.

[2]Although no precise figure is given, the staff report for the 1997 Article IV consultation noted that the stock of short-term debt was "low," suggesting a range of US$10 billion.

Figure A1.1. Indonesia: Selected Macroeconomic Indicators



Source: IMF.

current account deficit widened from 1.8 percent of GDP in 1992/93 to 3.3 percent in 1995/96, and to 3.5 percent in 1996/97.

The policy advice from the 1996 Article IV consultation mission, endorsed by the Executive Board, was that the authorities should follow tight fiscal and monetary policies, combined with faster external debt repayment. According to a former senior Indonesian official, Bank Indonesia (BI) made attempts to measure the capital inflows, an idea also endorsed by the Executive Board. This, however, sparked protests from the financial community, fearing that it was a precursor to imposing capital controls. Limitations were placed on the overseas borrowings of state enterprises, but the effectiveness of this initiative was uncertain.

The 1997 Article IV consultation report noted that the country was vulnerable to external shocks, and warned that excessive demand pressures were contributing to higher inflation and a wider current account deficit. The IMF advocated a tighter fiscal and monetary policy stance, greater exchange rate flexibility, and accelerated structural and banking sector reforms to maintain progress in reducing inflation, contain current account deficits, and minimize external risks. The IMF argued for a smaller current account deficit than the amount considered acceptable by the Indonesian authorities, who thought that a deficit of up to 4 percent of GDP was sustainable.

The authorities' views were based on the following factors:

- There were no strong indications of exchange rate overvaluation and non-oil exports were registering robust growth;[3]
- The current account deficit remained smaller than those in most ASEAN countries and was no higher than in 1991/92 and was significantly lower than the levels in Thailand (5–8 percent of GDP) and Mexico (6–7 percent) in the three years prior to the crises in those countries;
- The counterpart of the higher current account deficit was an increase in private sector investment to 27 percent of GDP in 1996 from 20 percent in 1992, likely contributing to faster economic growth; and
- Although debt was high by regional standards, it was evolving favorably with a stable and relatively low debt-service ratio of just over 30 percent, accompanied by a reduction of total external debt to under 50 percent of GDP in 1996/97 from 56 percent in 1991/92.

In retrospect, the elements that were missed in the authorities' analysis—and underemphasized by IMF surveillance—were the macroeconomic implications of short-term capital flows that were vulnerable to a sudden shift in market sentiment and the underlying weakness of seemingly buoyant private investment, much of which was in fact supported by imprudent lending and of questionable productivity.

Banking sector weaknesses

The risks from large and potentially volatile capital inflows were amplified by the poor quality of domestic financial intermediation and governance problems in the corporate and banking sectors. The fragile state of the banking system mainly resulted from the rapid deregulation following the so-called Pakto reform of 1988, which allowed a substantial increase in the number of banks without adequate prudential regulations.[4] Entry to the banking industry was made possible with a small amount of capital, but there were no adequate provisions for weak banks to exit.

A reasonable structure of prudential regulations had been put in place, in part with extensive techni-

[3]According to IMF data, the annual average real effective exchange rate was 97 in 1994/95, 99 in 1995/96, and 105 in 1996/97, with the base of 100 for 1990.

[4]In this context, Pincus and Ramli (1998) argue that Indonesia's fundamental mistake was to deregulate the banking sector in "deeply entrenched patrimonial state structures."

cal assistance received over the years from the World Bank, but this had little impact on the quality of banking, because enforcement was poor. Apart from the general problem of weak public administration, attempts to impose rules ran into stiff opposition from politically well-connected vested interests. This was demonstrated most clearly in the removal of the head of prudential supervision at BI in 1993, when he attempted to enforce connected lending limits on the largest of the private banks, which had close political connections. With this precedent, banks flouted prudential rules with impunity. The easy flow of financial resources to conglomerates through the banking system was facilitated by an international environment that encouraged flows of foreign capital into emerging markets.

Some academic researchers have argued that the Pakto reforms were designed to provide the well-connected with access to cheap money and created a process of financial flows closely approximating a "Ponzi" game (Cole, 2002). Indeed, banks affiliated with large conglomerates owned by the well-connected tapped the large pool of household savings and used the deposits to fund their own affiliated firms, often in risky or questionable ventures. Many of the loans were never repaid, while the owners paid themselves high interest rates on their deposits (Gie, 1993). BI dealt with the resulting insolvency by "nursing" the banks to health through long-term low-interest loans. The maturity of these loans could be as long as 30 years, with a grace period as long as 10 years and an interest rate as low as 1 percent.

The IMF correctly perceived that there were major problems in the state banking sector, an area where the World Bank was in the lead in the efforts to promote reform.[5] In several surveillance reports, the IMF staff alerted the Executive Board to the serious governance issues in the state banks and encouraged the authorities to move forcefully in this area. It is understandable against this background that the staff perceived the shift from public- to private-sector banks as a positive contribution to dealing with the problems of the banking sector. However, the dangers of poor governance in private sector banks appear to have been underplayed.

There were serious governance problems in the private sector banks. These problems first came to the knowledge of the IMF in 1994, when a technical assistance mission from MAE visited Indonesia. Upon examining the supervision data provided by BI, the MAE mission identified serious solvency problems in a number of private banks and learned that the problem banks were being effectively recapitalized with subsidized loans provided by BI, creating enormous moral hazard. The mission also came to view the "losses" of the banking system as largely representing transfers to conglomerates run by the well-connected. Despite these suspicions of corruption, however, there were no hard data to make the link between balance sheet weaknesses in the banks and governance failures. The confidential nature of technical assistance work meant that it was never presented to the Executive Board or widely discussed within the staff. However, the area department also did not explore the implications of warnings made by RES during the interval review process that there would be serious macroeconomic consequences from these vulnerabilities if there were confidence shocks.

These concerns were noted in surveillance reports but they were not adequately addressed, for example, by stress testing or exploring their potential policy implications. Drawing on the work of MAE, the background paper for the 1997 Article IV consultation observed that the main problems of the Indonesian banking sector were reflected in a high share of NPLs, incomplete compliance with prudential requirements by some banks, concentrated bank ownership and connected lending, continued operation of problem banks, and large exposure of banks to property loans. While the paper offered precise technical measures to address these problems, the governance and moral hazard issues identified by the earlier MAE missions were understated. A deposit insurance scheme, an idea recommended by MAE as a measure to increase confidence in the banking system, was taken up by the Selected Issues paper but was not followed up in the staff report.

In short, the nature of the main problem was identified and signaled to the Executive Board, but in a muted fashion. In line with the prevailing convention of the time that corruption should not be directly discussed, Board papers did not present an explicit assessment of the cronyism and corruption that created moral hazard in the banking sector. They also failed adequately to analyze the potential macroeconomic impact of shifts in market sentiment.

IMF surveillance noted that a number of reforms were being initiated by the authorities. For example, in 1996, six private banks were merged into three, and the authorities were considering merging the seven state banks. BI was encouraging problem banks to address their NPLs and the President issued a decree in December 1996 on the procedures for revoking the business licenses of banks and their dissolution and liquidation. In February 1997, the President approved the closure of seven banks to be

[5] The World Bank became engaged in the restructuring of large state banks through a Financial Sector Development Project. While the purpose of the World Bank project was to recapitalize and improve the operations of the problem state banks, the Bank became aware of serious governance problems in the summer of 1996 and eventually decided to suspend the project.

implemented after the elections, and BI strengthened the prudential regulations by requiring (1) a gradual increase of the capital-adequacy ratio to a minimum of 12 percent by 2001 and a minimum Rp 150 billion (around US$60 million) of paid-up capital for each foreign exchange bank; (2) rating of commercial paper issued and traded through banks; and (3) tougher selection standards for bank management positions. However, with the benefit of hindsight, the IMF appears to have been overly impressed by the initiatives that did not contribute substantively to addressing the underlying problems.

The weak banking system proved highly vulnerable to external shocks. Once the Thai crisis prompted a reassessment of potential risks throughout the region, foreign investors began to pull out of Indonesia, thereby drying up the previously plentiful source of low-cost financing to the corporate sector. The heavily indebted corporate sector found itself facing liquidity problems,[6] which were then compounded by a sharp exchange rate depreciation that raised the cost of servicing foreign debt. Conglomerate after conglomerate stopped servicing their loans, as the value of foreign currency debt doubled and then quadrupled in value. Foreign lenders rushed to close their exposure to Indonesia. At the time of the crisis, the banking system thus faced a huge portfolio of potential NPLs. This risk was on top of the system's own severe internal difficulties.

Of course, it is not possible to say with any certainty that the banking system would have been able to survive the massive exchange rate shocks of 1997–98, even if it had been stronger financially and with more robust governance. Nor is it possible to say that a more candid discussion of these issues as part of surveillance would have significantly affected domestic policies. Nevertheless, it is the case that the potential risks were not sufficiently flagged or analyzed. As a consequence, the knowledge of the underlying balance sheet vulnerabilities was relatively limited, when the crisis did hit.

Corruption and cronyism

Indonesia's vulnerability to crisis was greatly increased by the increase in corruption and its changing nature (Pincus and Ramli, 1998; Kenward, 2000; Lee, 2000; Booth, 2001; Cole, 2002). In the 1990s, there emerged a creeping return to restrictive business practices and rent-creating opportunities for the President's family and well-connected businessmen, with a corresponding weakening of regulatory and supervisory controls. For example, in 1996, the palm oil sector was closed to foreign investment, export bans and restrictions were introduced in a wide range of products, and impediments were placed on intraregional trade in livestock; in April 1997, the preshipment inspection system, a customs procedure designed to prevent corruption and managed by a foreign firm, was canceled although it had proved highly effective.

Originally, corruption in Indonesia was akin to a tax on the cost of a project, charged by and paid through established channels to maintain the stability of the political system (Charap and Harm, 1999). Even such corruption raises moral and equity concerns, but its impact on efficiency was said to be limited by the certainty and relatively low levels of the charge. In the early 1990s, however, the media began to see a change in the system of corruption, and to draw links with the empire building of the President's children and well-connected businessmen.[7] Corruption was being transformed into an ever-widening system of deliberate rent-creation for the well-connected, including the creation of monopolies and monopsonies, and exclusive rights to large industrial or infrastructure projects, such as the National Car Project.

These issues surfaced in discussions with the authorities in the precrisis period, and the staff consistently supported the World Bank's view that slippages in structural areas were damaging Indonesia's medium-term prospects. As noted, much of it involved favored treatment given to the First Family and close associates of the Palace, but some simply represented a continuation of the dirigiste tendencies that were still the way of doing business in Indonesia. The staff reports for the 1996 and 1997 Article IV consultations recommending renewed deregulation received broad support within the IMF, including from the Indonesian chair on the Executive Board. The 1997 report identified a list of structural reform measures that would later become the core elements of structural conditionality in the IMF-supported program (see Appendix A1.1).

It is difficult to determine the extent to which the staff was aware of the growing scale of corruption and its deleterious effects because it was customary at the time for governance issues to be dealt with only obliquely and indirectly in surveillance reports and Executive Board discussions. The staff took a technocratic approach of dealing with symptoms (i.e., creeping regulation) without explicitly addressing their underlying causes (i.e., cronyism), thereby blunting their analysis and Board discussion. An ex-

[6] Indonesia's average debt to equity ratio was high at 250 percent (Ghosh and others, 2002).

[7] See, for example, articles that appeared in the *Asian Wall Street Journal*, April 13 and October 24, 1994, and June 29 1995; and in the *Far Eastern Economic Review*, July 11, 1991, June 23, 1994, and February 9, 1995. The topic of changing business practices, particularly in Asia, also began to receive an increasing focus of attention in the academic literature (e.g., Fukuyama, 1995; Weidenbaum and Hughes, 1996).

plicit focus and candid Board discussions might have brought out more clearly the changing nature of corruption in Indonesia, and the macroeconomic risks it posed. Whether it would have had an impact in Indonesia is an open question, but at least it would have better prepared the IMF to deal with the crisis when it broke out.

Program Design

This section reviews major elements of program design in the IMF-supported programs in 1997 and 1998, with a focus on how the emphasis in program design changed from November 1997 to January 1998. The initial program was designed on the assumption that the crisis was essentially a moderate case of contagion and the implementation of a relatively conventional IMF-supported program would bring the rupiah back into a reasonable range. These expectations were belied and, toward the end of December, it became clear that the crisis in Indonesia was much more severe than elsewhere in the region. The crisis at this stage had become intensely political and there were doubts about whether the government was committed to the program. This led to the renegotiation of the program in January and a new LOI. The emphasis in program design switched to the establishment of structural conditionality to signal a new way of doing business in the hope that this would restore confidence.

Fiscal policy

Prior to approaching the IMF, the Indonesian authorities had already responded to the crisis by cutting public spending on low-productivity projects. This was meant both to facilitate the required current account adjustment and, more important, to help rebuild international confidence by signaling the authorities' determination to reduce dependence on capital inflows while improving governance.

The November 1997 program broadly endorsed this approach. In internal discussions, the First Deputy Managing Director moderated the fiscal targets proposed by staff and rejected proposals to increase the value-added tax (VAT), in order to avoid fiscal overkill at a time when output developments were uncertain. The program planned for a modest improvement in the fiscal position in fiscal year 1998/99 to cover partially the unknown carrying cost of bank restructuring (Table A1.1).[8] Specifically, the initial program, based on growth assumptions of 5 percent for 1997/98 and 3 percent for 1998/99, targeted:

- An overall budget surplus of 0.75 percent of GDP for 1997/98, compared with a surplus of 0.5 percent projected during the 1997 Article IV consultation, and a surplus of 1.3 percent during 1996/97;
- An overall budget surplus of 1.3 percent of GDP for 1998/99, though this was to be reviewed later in the light of developments before being fixed as a performance criterion;
- A reduction of capital spending amounting to 0.5 percent of GDP in 1997/98 and a further 0.5 percent cut in 1998/99 through postponing or canceling low-productivity projects (such as inter-island bridges);
- Cuts in operations and maintenance expenditures amounting to 0.25 percent of GDP in 1997/98 and a reduction in fuel subsidies amounting to 0.5 percent of GDP in 1998/99; and
- Various tax and expenditure measures, including higher excise taxes on tobacco and alcohol; lower transfers to state-owned enterprises and improved tax administration.

The Indonesian program has been extensively criticized for an overly contractionary fiscal and monetary stance which, according to some critics, actually made matters worse. As far as fiscal policy is concerned, the tightening proposed for 1997/98 was modest and reflected the basic assumption that Indonesia was suffering from a moderate case of contagion. The implementation of the program was expected to bring about a quick restoration of confidence and a recovery of the exchange rate, while growth would decelerate but still remain respectable.

The growth assumption on which the November program was based turned out to be far too optimistic and this was a fundamental weakness of the initial program design. While GDP growth in 1997/98 was 4.8 percent, only marginally lower than the 5 percent rate projected in the program, there was a collapse in 1998/99 with GDP declining by 13 percent instead of growing by 3 percent as projected. Some critics have attributed the collapse in output to the pursuit of tight fiscal and monetary policies in circumstances where these were not warranted, but the problem arguably lay elsewhere. The output collapse in 1998/99 was driven not by the stance of fiscal policy but by the near-collapse of private investment in the first and second quarters of 1998. Private investment is difficult to forecast over a business cycle and earlier studies have shown that IMF-supported programs tend to be overoptimistic about

[8] Until fiscal year 2000 (April–December), Indonesia's fiscal year ran from April 1 to March 31 of the following year. Thereafter, it corresponded to the calendar year.

Table A1.1. Indonesia: Fiscal Outomes and Targets

(In percent of GDP)

	1996/97	1997/98					1998/99					
	Outcome	Budget	Article IV projection	November 1997 without measures	November 1997 program	Outcome	November 1997 program	January 1998 program	April 1998 program	June 1998 review	November 1998 review	Outcome
Revenue	15.2	14.0	14.7	15.1	15.2	16.2	14.7	. . .	12.6	14.1	12.6	15.3
Expenditure	13.9	14.2	14.2	15.4	14.4	17.2	13.7	. . .	17.3	24.2	18.6	17.4
Of which:												
Subsidies	0.3	0.0	0.3	0.7	0.7	3.1	0.2	. . .	2.3	6.2	4.3	4.2
Capital	5.7	5.9	5.3	6.2	5.6	6.6	5.2	. . .	5.7	7.1	7.1	5.1
Overall balance	1.3	–0.2	0.5	–0.3	0.8	–1.0	1.0	–1.0	–4.7	–10.1	–6.0	–2.1
Memorandum item:												
GDP growth	8.0	8.0	8.0	5.0	5.0	4.6	3.0	0.0	–5.0	–12.1		–13.6

Sources: IMF staff reports; and IEO staff estimates.

private investment (Goldsbrough and others, 1996). In Indonesia, the collapse of private investment was especially severe because of (1) the unexpectedly large exchange rate depreciation in a situation where corporations had borrowed heavily in foreign exchange, and (2) the impact of political developments—including especially rioting against the ethnic Chinese community—on business confidence.

The role of fiscal policy in the Indonesian crisis needs to be evaluated in this broader context of larger forces driving developments in the real economy. The November 1997 program implied modest tightening in 1997/98 and further tightening in 1998/99, but it also stated that the fiscal target for 1998/99 would be updated and converted to a performance criterion at the time of the first review in January 1998, taking into account, inter alia, output developments (see Appendix A1.1). Unfortunately, these provisions incorporating flexibility were not made public. The 1998/99 draft budget presented by the government on January 6, 1998, which proposed zero deficit, appeared to violate the terms of the agreement with the IMF and triggered speculation in the press that it might signal a possible withdrawal of IMF support.[9] In fact, by the time the 1998/99 draft budget was put together in the latter part of December, it was known that the growth forecast for 1998/99 would need to be revised downward and internal documents and interviews make clear that a consensus had emerged within the IMF that a surplus was not appropriate under the conditions that were then prevailing or were likely to prevail in Indonesia.[10] The IMF did issue a statement of support for the announced budget within two days. The confusion could have been avoided if the authorities had consulted with the IMF before they released the draft budget, explaining that the overall balance differed from that in the November program because the situation had changed and that this was done in full consultation with the IMF.

The second LOI agreed in mid-January 1998 reduced the earlier 3 percent growth projection to zero growth and provided for a relaxation of the fiscal stance to a deficit of 1 percent of GDP for 1998/99. The third LOI signed in April 1998, which was the operationally relevant one for the 1998/99 budget, further raised the programmed overall deficit to 4.7 percent of GDP, acknowledging the need for temporary subsidies to protect the poor, while proposing a further cut in low-priority projects in the development budget. As the sharper output decline became more evident in the following months, the subsequent LOI in June 1998 further relaxed the fiscal target to a deficit of 10.1 percent of GDP, the largest in any IMF-supported program.

The actual budget deficit in 1998/99, at 2.1 percent of GDP, was much smaller than programmed. Fiscal policy was therefore much more contractionary than allowed under the program. In part, this resulted from institutional inflexibilities in using fiscal policy in a countercyclical manner, in the absence of preexisting social safety nets that would automatically be activated in an economic downturn. The failure of the authorities to use all the fiscal room provided in the program also reflected the fiscal conservatism of the Ministry of Finance and the limited implementation capacity of the Indonesian government in general. The absence of a government bond market also limited the ability of the authorities to finance expenditures through noninflationary means, imposing another constraint in operating fiscal policy countercyclically. Thus, the main countercyclical element realized was on the revenue side, as the targeted increases in spending were not met (Table A1.1).

In retrospect, the IMF was slow to recognize that the decline in GDP was being driven in large part by the collapse in investment. In April 1998, when the sharp contraction in investment should have been clear, the staff report for the first review simply noted that economic activity had fallen off "markedly" during the second half of 1997/98, "especially in construction and services," without mentioning the behavior of private investment. It is only in August 1998 that this feature was noted and the EFF request projected a remarkable decline of private investment from an estimated 22.5 percent of GDP in 1997/98 to 9.2 percent of GDP in 1998/99. Even then, there was no explanation of why investment had collapsed to this extent, suggesting that the IMF may not have focused sufficiently on one of the key forces driving the adverse macroeconomic outcome.

Interest rate policy and monetary targets

Contrary to the widespread image that the IMF mechanically pushed for high interest rates, internal documents make clear that there was in fact considerable debate among staff on the best way to deal with the situation. The staff was fully aware of the basic dilemma: a large exchange rate depreciation would bankrupt many firms (and thereby adversely impact the banking system), while any interest rate high enough to support the exchange rate was also likely to have similar adverse effects on balance sheets.

[9]A *Washington Post* article of January 7, 1998 emphasized the lack of commitment to the reform program and only mentioned in passing that analysts perceived that the budget unveiled by the authorities had made suspension of the program more likely.

[10]In late December 1997 and early January 1998, the staff expected no growth in 1998/99 and did not yet anticipate collapse of output in the first and second quarters of 1998. The output collapse was in large part driven by political developments. There were also negative balance sheet effects on investment, resulting from the sharp depreciation of the rupiah.

Interest rate policy

The Policy Development and Review Department (PDR) and MAE argued for tight monetary policy with high interest rates. PDR argued that the corporate and banking sectors could not bear the added costs from any further depreciation, and recommended foreign exchange market intervention supported by tight monetary policy. Interest rates were to be raised temporarily at the outset of the program to signal the commitment of the authorities to exchange rate stability and to encourage nominal appreciation of the exchange rate following the intervention. MAE supported high interest rate policy to achieve an early exchange rate appreciation, but expressed reservations on the benefit of extensive early foreign exchange market intervention.

On the other hand, RES and APD argued against further tightening monetary policy and raising interest rates. RES was concerned that an interest rate defense was not feasible with a weak banking system and a vulnerable corporate sector. It pointed out that if confidence remained low, the agreed intervention limits would be reached and higher interest rates would be required to defend the exchange rate. But higher interest rates would damage the corporate and banking sectors, thereby further eroding confidence.

During the program negotiations, the APD mission argued that it would not be desirable to support the exchange rate solely through monetary tightening, especially because monetary conditions were already tight. Instead, it advocated a policy of giving the authorities more flexibility to intervene when necessary, without further tightening monetary conditions. The mission also pointed out that, on a practical level, BI was reluctant to raise SBI rates, when it had already done so unsuccessfully in August 1997. The mission noted that, as early as September, the central bank Governor had begun to reduce interest rates and was still talking in terms of further reducing the rates.

The business community in Indonesia was calling for lower interest rates, and market participants were discussing the problems associated with maintaining high interest rates for a long period. By early September 1997, market commentary was suggesting that the balance sheets of Indonesian firms had been severely damaged by high interest rates and the weaker exchange rate. By the end of the month, tight liquidity was a serious concern for the banking sector, as the banks' portfolios had deteriorated rapidly as a result of their exposure to corporate borrowers with a large amount of unhedged foreign currency–denominated debt.[11]

The differences between RES and APD, on the one hand, and PDR and MAE, on the other, reflect the dilemma of designing crisis management policies in the face of a twin crisis affecting both the external sector and the banking sector, with policies aimed at addressing one problem causing problems in the other. However, while the problem was posed, there was no satisfactory way of resolving the dilemma. The policy that finally emerged from the debate represented a compromise: to keep monetary policy tight without setting specific interest rate targets. BI would maintain the one-month SBI rate at 20 percent but would raise it if needed to support foreign exchange market intervention. In approving the program, no Executive Director explicitly opposed the strategy; several Directors, however, expressed strong dissatisfaction with the lack of specific and sufficiently tight monetary action.

Less than a week after the program was launched, the staff was alarmed by the apparent loosening of monetary policy reflected in a fall in interbank rates and urged BI not to lower interest rates prematurely. Initially, during the first week of November, the rupiah had appreciated from Rp 3,600 to Rp 3,250–3,300 per U.S. dollar, supported by coordinated foreign exchange market intervention (with Japan and Singapore), and the Jakarta interbank offered rate (JIBOR) began to rise. These gains, however, were not supported by sustained high interest rates, with the SBI rate remaining virtually constant (Figure A1.2).[12]

BI argued that JIBOR was not a good measure of the stance of monetary policy. The interbank market had become more segmented than usual between foreign and state banks with adequate liquidity positions, on the one hand, and private banks with increasingly difficult liquidity positions, on the other. BI was urging first-tier banks to lend to other banks with assurances that there would be no second round of bank closures. At the same time, BI was providing liquidity to second- and third-tier banks at a rate lower than JIBOR. Staff was concerned that the injection of liquidity might cause monetary targets to be breached. In the second half of November, a mission was dispatched to assess the situation.

The strategy of intervening in foreign exchange markets presented a further complication, given the already tight liquidity situation caused by the mone-

[11]See, for example, investors' comments reported in the Bloomberg News on September 4, 1997 (quoting analysts at Peregrine in Jakarta and Hong Kong SAR) and September 26, 1997 (quoting an analyst at Merrill Lynch Asia Pacific).

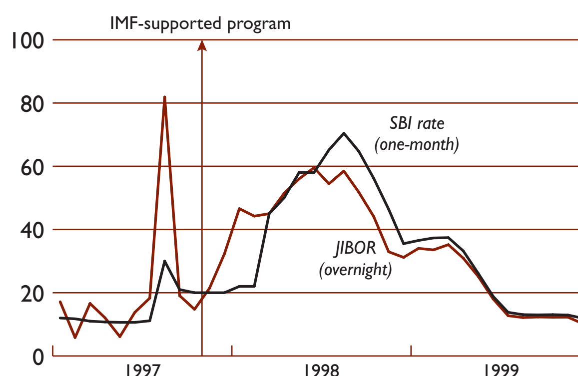
[12]In fact, BI took only a small interest rate action. What happened was that interbank interest rates rose sharply when BI only partially sterilized intervention. When BI found some banks failing to clear at settlement, it injected liquidity, causing interbank rates to decline.

tary squeeze of August.[13] Intervention of some US$5 billion in the last quarter of 1997 was equivalent to one-third of the stock of base money at the end of September 1997. As the intervention was to be only partially sterilized, this left a large segment of the banking sector short of liquidity when settlement came. BI claimed to have no alternative but to provide liquidity but, as a result, the rupiah only strengthened for two days before sliding, by the end of November, to its level of October.

With the exchange rate sliding almost continuously, it was clear that the original expectation of a quick recovery would not be realized. The IMF urged an immediate rise in the SBI rate by 5 percentage points as a first step and by more if needed, in accordance with the understanding on which the program was based. The IMF also urged that, as agreed in the program, liquidity support should only be offered at market rates and against collateral and that additional banks should be closed if necessary. However, President Suharto ordered an immediate reduction of 5 percentage points in the SBI rate (which the economic team did not implement). He also signaled that there should be no more bank closures. With conflicting demands on monetary policy coming from the IMF and the President, the economic team by this time had all but lost access to the President and could take no effective action.

Our evaluation suggests that the criticism that the high interest rate policy pushed by the IMF was responsible for the collapse in Indonesia is not well founded for the simple reason that the IMF's recommendations in this respect were never implemented. Interest rates were not raised despite repeated IMF urging. Instead, liquidity was expanded and resulted in a loss of monetary control (Box A.1). As a result, real interest rates were substantially negative (Figure A1.3). It was only after March 23, 1998 that the new economic team was able to raise nominal interest rates, pushing up the one-month SBI rate to 45 percent from 22 percent. The exchange rate steadily appreciated from Rp 9,750 per U.S. dollar the previous week to Rp 7,500 by mid-April and remained below

Figure A1.2. Indonesia: Monthly Nominal Interest Rates
(In percent a year, at the end of the month)



Sources: Bloomberg; and University of Indonesia, Institute for Economic and Social Research.

Rp 8,000 until the May troubles, which provoked a further depreciation (Figure A1.4).

Monetary targets

Performance criteria for base money were set for end-December 1997 and end-March 1998, and indicative targets for end-June 1998 and end-September 1998. Base money was to grow by 4 percent in the last quarter of 1997 and to remain more or less flat in the first quarter of 1998. In the event, unlimited liquidity support from BI to the banking sector led to a virtual explosion in base money, which grew by 14 percent in the last quarter of 1997 and a further 32 percent in the first quarter of 1998, before its growth slowed down to 12 percent in the second quarter and finally to 2 percent in the third quarter (Figure A1.5).

While central bank liquidity support expanded sharply during the IMF-supported program, BI was already providing lender of last resort (LOLR) support to several banks experiencing shortages of liquidity well before the program. As the crisis developed, LOLR support was provided under a variety of schemes, which were later consolidated under the general title of Bank Liquidity from Bank Indonesia (BLBI) early in 1998. With the greater segmentation of the interbank market in the final quarter of 1997, the LOLR role of BI became all the more important. By the end of January 1998, total support under BLBI had reached 5 percent of GDP, or close to 100 percent of base money.

BI operated under severe constraints. When a bank had a shortfall at clearing, BI had to either supply the needed liquidity, or else close down or take over the bank immediately (Djiwandono, 2002). In November 1997, the Cabinet had decided, in accor-

[13]According to the BI Governor, liquidity problems in the banking sector developed as a result of monetary and fiscal tightening in August 1997. Weak banks began to experience distress and bank runs emerged in the second half of the month. Interbank rates increased from an average of 22 percent to more than 80 percent (see Figure A1.2). By the end of August, "more than 50 banks had failed to comply with the minimum reserve requirement of 5 percent" (Djiwandono, 2000). In the technical files of MAE, however, there is nothing to indicate a systemic liquidity problem and it is not clear if the whole system became illiquid or if the problem was limited to weak banks and those subject to runs. Market segmentation, however, does seem to indicate that at least the first-tier banks (e.g., the JIBOR banks) were not short of liquidity.

Box A1.1. Indonesia: Was Monetary Policy Tight?

IMF staff has argued that monetary policy was never tight in Indonesia, because most standard measures of real interest rates were negative from the inception of the program to early 1999 (Lane and others, 1999; Boorman and others, 2000; Ghosh and others, 2002). It is true that, for the first five months of the program, the Indonesian authorities hardly raised the policy interest rate despite urging from the IMF. It was only in March 1998 that, for the first time under the program, BI substantially increased the SBI rate. The one-month rate rose from 22 percent to 45 percent and reached, after several rounds of increases, 70 percent in August 1998.

The assessment of monetary policy under the IMF-supported program is made difficult by several factors:

- Before IMF assistance was requested, in August 1997, BI had already raised the one-month SBI rate from 10–12 percent to more than 30 percent. However, under pressure from the President, BI was forced to reduce the rate to around 20 percent in September 1997.
- With a sharp depreciation of the currency, relative prices in the economy were rapidly changing and the impact of interest rates was different in tradable and nontradable sectors. Real interest rates faced by the nontradable sector likely remained positive—and substantially so—during this period, while they were substantially negative for the tradable sector.
- The banking crisis led to a greater segmentation of the interbank market with a shift of deposits within the banking system. At least initially, 24 of the major institutions—the so-called JIBOR banks—had plentiful liquidity, while other banks found it difficult to raise funds at any interest rate. The high nominal interest rates faced by these banks reflected a large risk premium, not a particular stance of monetary policy.
- BI provided liberal liquidity support to all banks experiencing liquidity problems, so that high interbank interest rates did not present an issue for these banks.
- Continued pressure on the rupiah meant that Indonesian interest rates included a component reflecting the expected rate of depreciation.

It is fair to say that while high real interest rates were faced by some potential individual borrowers at different points in time, the stance of monetary policy as a tool of macroeconomic policy was never tight and, contrary to the wishes of the IMF, did not become any tighter as a result of the IMF-supported program. Moreover, market segmentation, always a feature of the Indonesian system, worsened markedly and intermediation spreads in the banking system became negative as banks attempted to keep payments current. There was, however, a period of tight monetary policy prior to the inception of the program which, according to the BI Governor and market observers, had adverse consequences for the corporate and banking sectors.

A related issue is whether or not high interest rate policy caused a credit crunch, a situation where existing demand for credit is not fully satisfied at a given interest rate. In the case of Indonesia, as banks experienced liquidity and then solvency problems, the supply of credit clearly fell. At the same time, as the balance sheets of many firms were adversely affected by the sharp depreciation of the rupiah, the number of creditworthy borrowers also declined. To identify a credit crunch is inherently a difficult exercise, because it requires the identification of both demand and supply. A study by IMF staff argues that there was a credit crunch in Indonesia as the banking crisis deepened, but that the crunch disappeared when the demand for credit fell (Ghosh and Ghosh, 1999). The aggregate picture, however, may not tell the whole story about potential individual borrowers, particularly small and medium-sized enterprises (SMEs) with no recourse to nonbank financing (Yoshitomi and Ohno, 1999). There was evidence of some unsatisfied credit need, mainly reflecting supply factors (Bank Indonesia, 2001). Given the likely impact on the ability of banks to provide financial intermediation, a strategy to deal with the financing needs of viable SMEs would have been helpful, although it is inherently difficult to design such a strategy.

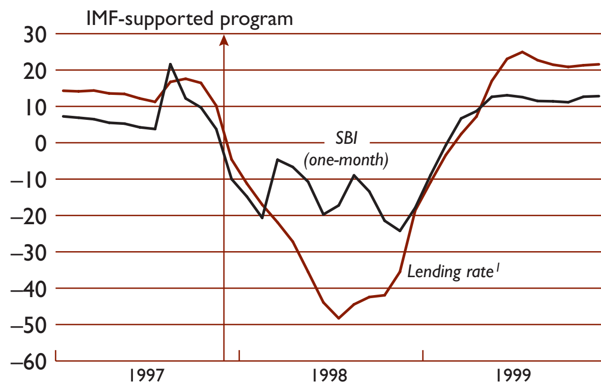
dance with commitments under the program, to provide LOLR only to solvent banks, but both the BI Governor and the Minister of Finance were certain that the President did not want any more banks to close. Without willingness on the part of BI to intervene in some other way, these two objectives were mutually incompatible.

In this climate, liquidity support served both legitimate LOLR and fraudulent purposes. Together with third-party depositors withdrawing funds in a "flight to safety," some bank owners were stripping assets. In parallel, liquidity support also went to cover large off-balance-sheet exposures in foreign exchange. This was particularly evident in early 1998, when the exchange rate plummeted and the banks could no longer borrow foreign exchange in the interbank market. This led to an explosion in liquidity support during that period. The increasingly negative intermediation spreads, as banks tried to keep payments current, added to insolvency and illiquidity that contributed to a buildup in liquidity support.

By the time the situation stabilized in mid-1998, the volume of liquidity injected through BLBI amounted to around Rp 144 trillion (or 14 percent

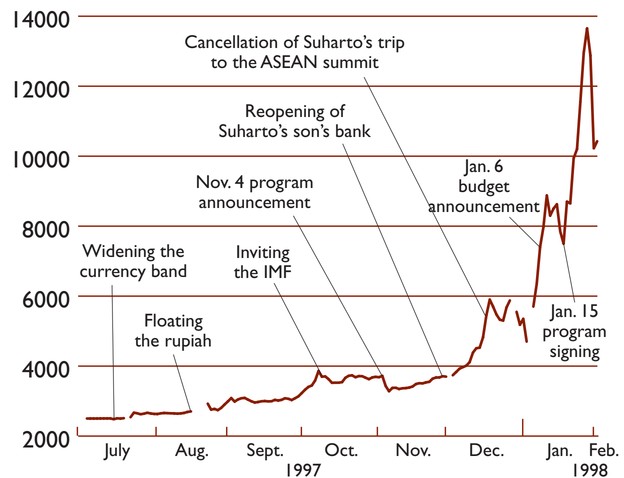
Figure A1.3. Indonesia: Monthly Real Interest Rates

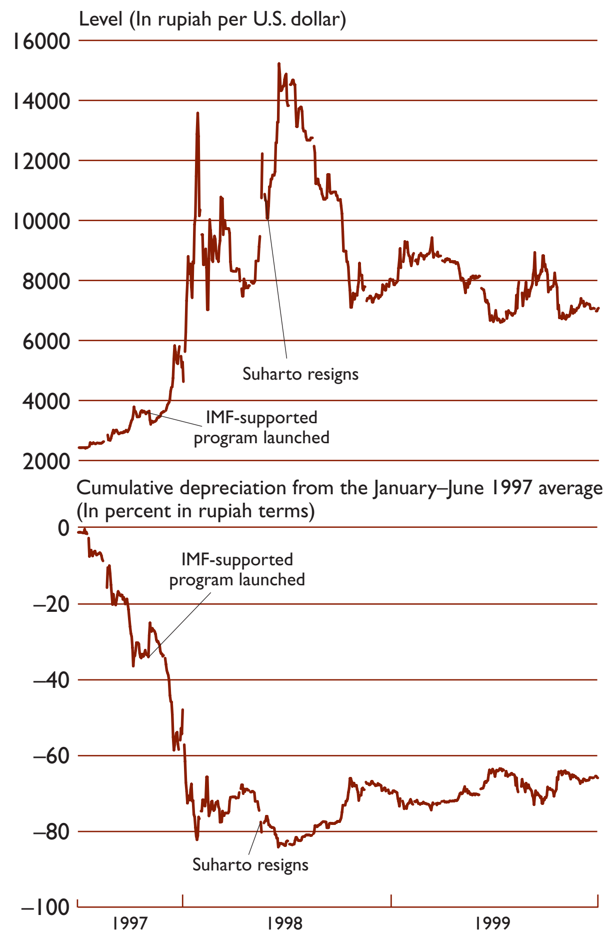
(In percent a year)



Source: University of Indonesia, Institute for Economic and Social Research.
[1]The lending rate is for working capital, deflated by actual two-month-ahead CPI inflation.

Figure A1.4. Indonesia: Daily Movements of the Rupiah–U.S. Dollar Exchange Rate





Source: University of Indonesia, Institute for Economic and Social Research.

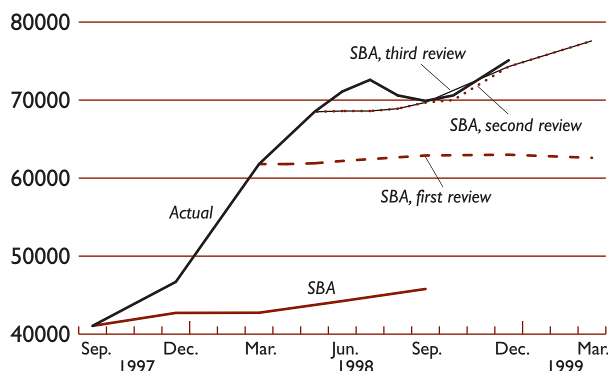
of GDP). In the initial phase, penalty rates were imposed on BLBI, which were then capitalized, leading to a steady rise in the outstanding volume of BLBI. When it was recognized that this was not serving any purpose, the rates were reduced. As BLBI was unsecured, the bank owners were required to provide personal guarantees, which later became the basis of the shareholder settlements administered by IBRA.[14]

Once BLBI support became routine, moral hazard became real. According to the official report of the Supreme Audit Agency (BPK), irregular practices dominated the administration of BLBI, with Rp 82 trillion out of total Rp 144 trillion judged to have been misused.[15] It should be noted that the report took a legalistic approach and thus characterized any violation of central bank rules as fraudulent, which

[14]While liquidity support in principle required collateral, for a variety of reasons, there was little collateral available in 1997–98, which necessitated the pledge of personal guarantees from the bank owners that their banks met the conditions for liquidity support. With the subsequent discovery that many of these pledges were in fact invalid, in most cases because the banks had breached the legal lending limits, the owners became liable for making the repayment. Under the so-called shareholder settlements, IBRA was to recover such funds from the respective owners, but the nonimplementation of commitments and manipulation of the process resulted in large LOLR losses.

[15]The report was prepared at the request of Parliament, in cooperation with the Finance and Development Supervisory Body (BPKP), with Price Waterhouse serving as a consultant. BPK audited all allocations of BLBI to 48 troubled institutions as well as the use of funds by 5 "Take Over Banks" (BTOs) and 15 liquidated banks (BDLs). BPKP audited the use of BLBI by 10 "Frozen Operation Banks" (BBOs) and 18 "Frozen Trading Activities Banks" (BBKU).

Figure A1.5. Indonesia: Base Money Outcomes and Targets Under IMF-Supported Programs



Source: IMF documents.

likely overestimated the economic cost of corruption. However, it is certain that BLBI not only raised the cost of saving the banking system, but also contributed to greater exchange rate depreciation by effectively funding capital flight.

Almost all of the BLBI went to private banks, except for the special case of the state-owned Bank EXIM. The liquidity support to Bank EXIM was not in response to deposit withdrawals but rather to fraudulent losses in the bank's treasury operations. BLBI was concentrated in a handful of institutions, with EXIM and three private banks (BCA, Danamon, and BDNI) receiving 75 percent of the total. This concentration of BLBI implies that pressure was not necessarily on the overall financial system. The case of Bank EXIM is particularly noteworthy, as state banks benefited from the shift of deposits from the private banks (given the implicit deposit guarantee by the government).

Interviews with staff and a review of internal documents make clear that the staff was not fully aware of governance problems in the injection of liquidity until January or February of 1998. Thus, although the IMF staff was in daily contact with the authorities and monitored the amount of liquidity support, the IMF did not capture the extent of irregularities in the support operations during the crucial months of November and December, when monetary control was lost.

Exchange rate policy and capital controls

The rupiah was floated in August 1997 at the outset of the crisis before the IMF program was negotiated, and this decision was welcomed by the IMF. Nevertheless, in view of sustained downward pressure on the rupiah, the IMF staff, during the review of the brief for the October 1997 mission, discussed the idea of introducing capital controls. The idea was quickly dropped because of the likelihood that controls could not be administered effectively in a country with widespread corruption and weak administrative capacity. The Indonesian authorities told the evaluation team that they had never considered introducing capital controls, knowing that there was no infrastructure to administer such a system effectively. They also pointed out that one of the reasons for abolishing controls in the 1970s in the first place had been their ineffectiveness due to corruption.

By December 1997, the rupiah had depreciated substantially more than the currencies of the other crisis-hit economies of the region, and was continuing to depreciate, indicating that the Indonesian crisis was exceptional. In part, this reflected political developments. The illness of President Suharto in early December injected new sources of uncertainty as succession concerns surfaced prominently, and politically motivated attacks on the ethnic Chinese community also intensified.

With the currency in virtual free-fall from December through January, even after the signing of the revised LOI, both the IMF and President Suharto independently began to consider introducing a currency board arrangement (CBA). In Indonesia, business interests close to the President initiated the idea and invited an American academic expert to advise on the subject (Hanke, 1998b). The idea of formally introducing a CBA was declared by the President in February 1998. There was widespread though unsubstantiated concern, including within the IMF, that if the CBA were adopted, the rate would be Rp 5,000 per U.S. dollar, around half the going market rate, and that its supporters would use it to convert their rupiah holdings into U.S. dollars.

There were some advocates for the CBA within the IMF, but a consensus soon emerged that the existing conditions in Indonesia, including the weak banking system and the absence of respect for rule of law, were not appropriate for a CBA, at least over the short to medium term. On February 11, the IMF took a firm stance on the issue by sending a letter to the Indonesian authorities opposing the CBA and explaining why it was not appropriate for Indonesia at that time. A stalemate continued until the major IMF shareholder governments, including Germany, Japan, and the United States, stated their unequivocal opposition, through high-level contacts with President Suharto.

Official financing

As noted in the main report, determining the size of access in a program designed to build confidence is an inherently difficult exercise, because the residual financing need is endogenous to the effectiveness

Table A1.2. Indonesia: Balance of Payments Projections and Outcomes
(In billions of U.S. dollars)

		1997/98			1998/99		
	1996/97	November program	April program	Actual	November program	April program	Actual
Current account	–7.7	–5.8	–2.3	–1.7	–4.9	4.3	4.3
Exports	52.1	55.6	56.3	56.2	60.8	58.8	48.3
Imports	–50.9	–50.4	–48.5	–47.4	–55.6	–42.3	–33.7
Goods and services	–8.9	–11.0	–10.1	–10.5	–10.1	–12.2	–10.3
Capital account	13.8	–0.5	–13.5	–11.7	0.9	–14.2	–1.8
Long term	4.5	3.1	2.3	3.2	2.1	5.0	6.7
Official	–2.0	–0.4	0.5	1.4	–1.0	4.5	6.6
Direct investment	6.5	3.5	1.8	1.8	3.1	0.5	0.1
Other	9.3	–3.6	–15.8	–14.9	–1.2	–19.2	–8.5
Errors and omissions	1.6	0.5	–0.1	. . .	0.0	0.0	. . .
Other	7.7	–4.1	–15.7	. . .	–1.2	–19.2	. . .
Oil/gas export credits	0.1	0.1	. . .	. . .	0.1	. . .	. . .
Portfolio investment	1.7	–1.7	. . .	. . .	–1.0	. . .	. . .
Other private capital	8.3	–1.6	. . .	. . .	–0.3	. . .	. . .
Monetary movements of commercial banks	–2.4	–0.9	. . .	. . .	0.0	. . .	. . .
Overall balance	6.1	–6.3	–15.8	–13.4	–4.0	–9.9	2.5
Change in gross foreign assets of Bank Indonesia	–6.1	0.2	10.2	10.2	0.5	–6.7	–9.4
Financing need	0.0	6.1	5.6	3.2	3.5	16.6	6.9
IMF	0.0	6.1	3.0	3.1	2.6	5.3	6.8
Asian Development Bank, World Bank and exceptional financing	0.0	0.0	2.6	0.1	0.9	11.3	0.1
Memorandum item:							
Gross foreign assets of Bank Indonesia (end of period)	26.6	26.4	16.4	16.4	25.9	23.1	25.8

Sources: IMF Staff Reports; and IEO staff estimates.

and speed with which confidence is restored. This also makes difficult our evaluation of the size of access in Indonesia, which was based on a projection of the likely balance of payments need under certain assumptions.

The IMF assumed that the current account deficit in 1997/98 would show a small improvement of about US$2 billion compared to the previous year, but this would be accompanied by a large deterioration in the capital account of about US$14 billion, reflecting failure to rollover short-term debt, withdrawal of portfolio investment, and lower net FDI flows (Table A1.2). The program also aimed to stabilize the level of gross foreign assets of BI at about US$26 billion.

Given these assumptions, the IMF determined that an amount equal to one-third of the short-term debt of US$33 billion (i.e., US$11 billion) would need to be financed over the two years 1997/98 and 1998/99. In calculating access, however, it used the more conservative figure of US$22 billion (or two-thirds of the total short-term debt) as the amount that was required to meet short-term obligations over the first year of the program. Access from the IMF was thus set at US$10 billion (490 percent of quota), after taking account of additional multilateral financing of about US$8 billion from the World Bank (US$4.5 billion) and the ADB (US$3.5 billion), and the use of US$5 billion of BI's own reserves if needed.[16] Of the US$10 billion to be provided by the IMF, US$8.7 billion was to be disbursed over the first two years, with US$6.1 billion for 1997/98 and US$2.6 billion for 1998/99.

The program also incorporated a substantial foreign exchange market intervention of up to US$7.5 billion over the first three months of the program, with up to US$5 billion during the month of November alone. In the event, the improvement in the current account was much larger, at US$6 billion, and the reversal of capital flows was much worse than projected. Compared with the net inflow of some US$14 billion in 1996/97, the November program had projected a net outflow of US$0.5 billion for

[16]In view of the high level of reserves, it was assumed that BI could temporarily cover delays in the disbursement of multilateral resources from the other IFIs.

1997/98. The actual outcome was a net outflow of some US$12 billion in 1997/98, including capital flight by domestic residents.

The working assumption that only one-third of the short-term debt would be rolled over was not unreasonable, as were the rest of the balance of payments assumptions. In retrospect, the projections were belied by large-scale capital flight by domestic residents, which became ever larger over time. As a result, what had seemed a reasonable package ex ante began to look inadequate as confidence collapsed.

In our view, the size of financing was not the cause of the failure of the November program. The origin of the failure was the inadequacy in program implementation and the associated rapid expansion of liquidity, and this technical failure was soon transformed into a political crisis, which undermined business confidence especially among the ethnic Chinese business community. At the technical level, the main oversight was the failure to take into account the unknown but large amount of short-term interbank lines of credit essential to finance imports. Trade credits were not rolled over and this exacerbated the crisis until the spring of 1998, when explicit efforts began to be made by the IMF and its major shareholder governments to encourage major commercial banks to do so.

Bank closure and restructuring

The need to reform the banking system had been identified in surveillance and measures to this effect were rightly included in the program. As noted in the main report, in October 1997, the MAE team, collaborating with teams from the World Bank and the ADB, examined the supervisory data provided by BI and concluded that at that time intervention was needed for only a limited number of private banks. This assessment turned out to be a serious underestimation of the true state of the banking sector. The reality at the time was that, except for foreign banks, state banks, and a few large private banks, much of the rest of the banking system was illiquid and possibly on the verge of insolvency.[17]

The IMF reached its assessment in the following manner. Using the June 1997 data, the World Bank reviewed all 7 state banks (accounting for 40 percent of total banking sector assets); the ADB, 13 out of 27 regional development banks (2 percent of total banking sector assets); and MAE, 72 out of 160 private banks (43 percent of total banking sector assets and 87 percent of total private banking sector assets). Taken together, the combined IFI team investigated 92 out of 238 banks, accounting for 85 percent of market share.

Exclusive reliance on BI data proved to be a major problem for two reasons. First, the June 1997 data were not the right basis for making solvency assessments, given the exchange rate depreciation that had occurred since then. Second, supervisory information from BI was flawed by the low level of supervisory skills and, according to some observers, suspicions of corruption. This was clear from a widely known academic work (Cole and Slade, 1996) as well as from the findings of the World Bank's financial sector mission in 1996. The IMF staff did go beyond official data and asked the heads of large banks how the crisis had affected their balance sheets and also discussed the likely current balance sheets of banks with BI supervisors, bank by bank. However, these inquiries did not in most cases lead to a significantly more negative assessment.

The combined team identified 50 vulnerable banks, of which 34 banks were judged insolvent, including 26 private banks, 2 state banks, and 6 regional development banks. Another 3 private banks were on the borderline of solvency, requiring rehabilitation. The remaining 13 (out of the 50 vulnerable) banks were found to have diverse weaknesses, including capital adequacy ratios below the required minimum for some, and needed to be placed under intensified supervision. According to MAE, the 34 banks identified as insolvent accounted for about 15 percent of total banking sector assets, with the 26 private banks alone accounting for 5 percent.

The extent to which the IMF missed the scale of the problem is obviously crucial in making an ex post evaluation. Internal documents and interviews indicate that there was a considerable debate within the staff over the extent to which Indonesia faced a systemic banking problem. Some APD staff argued that the MAE analysis was too sanguine because it assumed that (1) there were a relatively few bad banks in an otherwise sound banking system, when the whole banking sector had become vulnerable as the exchange rate had depreciated and interest rates had risen; and (2) runs were caused by small and ignorant depositors, while it was in fact the high-wealth individuals with inside information who were withdrawing deposits.[18] However, these concerns were downplayed and therefore not reported in the staff report accompanying the November SBA request to the Executive Board. MAE insisted until January 1998 that the banking system was sound except for the 50 banks

[17]Some on the IMF staff hold the view that most banks would have remained solvent if the exchange rate had recovered to the programmed target range of Rp 3,000 to Rp 3,500.

[18]For example, Bank Danamon, a large retail bank, had experienced sporadic runs even before the IMF was called in and, by end-October 1997, had already received Rp 3.5 trillion of liquidity support.

identified, and that no data existed to support the contrary view. Even so, the MAE mission did note in its back-to-office report, dated November 11, 1997, that there might be other problem banks than the sample reviewed; NPLs might have been underestimated; and some banks not identified for action might have deteriorated since June 1997.

In any case, it is unlikely that identification of deeper sickness would have led to corrective action. BI argued that it could only close 16 of the 26 insolvent private banks (accounting for only 3 percent of total banking sector assets) because the other 10 had "nursing" agreements with BI, which legally prevented closure unless rehabilitation efforts failed.[19] Among the banks to be closed were three connected with the President's family: Bank Andromeda, in which one of his sons had a minority ownership; Bank Industri, with partial ownership by a daughter; and Bank Jakarta, with some ownership by his half-brother.

A critical program design decision was the nature of a guarantee for depositors of closed banks. There was a consensus between the authorities and the IMF staff that a blanket guarantee would not be desirable on grounds of both fiscal cost (emphasized by the Indonesians) and moral hazard (emphasized by the IMF). It was agreed that depositors of the closed banks would receive up to Rp 20 million (about US$6,000), covering 93 percent of the accounts and 20 percent of the deposits in the closed banks.

Initially, the closure of the 16 banks and the tough statement from the Minister of Finance that henceforth all banks allowed to become insolvent by their owners would be closed down was welcomed, as it seemed to imply a new way of doing business. However, several factors undermined the credibility of this policy. Most important, the President's family challenged the closures. His son arranged for the business operations of Bank Andromeda to be shifted to another bank in which he had acquired an interest. The President's half-brother initiated a legal challenge to the closure of his bank. The public also saw some inconsistency in the closure of 16 banks, when it was widely—and correctly—believed that many other banks were also in a similar condition. The authorities insisted on secrecy regarding the nursed banks and, as a result, the public had no idea of what was being done to address the wider problem.

BI also did not make an adequate effort to communicate its bank-closure policy to the public. There were flip-flops in announced government policy. Under pressure from the President, the Minister of Finance soon reversed his previously announced tough position, saying that there would be no more bank closures. Some private individuals told the evaluation team that uncertainty had been compounded by lack of clear information on how and how quickly depositors would have access to their funds. In the event, by the end of November 1997, two-thirds of the 222 banks had experienced runs. Rp 12 trillion (or about US$2.7 billion) of rupiah deposits shifted to large private banks, foreign banks, and state banks, and about US$2 billion of U.S. dollar funds left the banking system entirely.

It was not until the end of January 1998, in the face of continuing banking sector problems, that the authorities accepted the banking strategy proposed by the IMF, involving a comprehensive bank restructuring plan, a general guarantee scheme, and the creation of the IBRA as a combined bank-restructuring and centralized-public-asset-management agency. The new strategy initially succeeded in stemming the exit of deposits from the banking system, and the appreciation that followed the announcement of the end-January banking and corporate debt measures was not fully reversed for almost four months, until the ethnic riots in May 1998.

The negative experience of November 1997 can be contrasted with what happened in early April 1998, when 7 banks representing 16 percent of banking sector assets were taken over by the IBRA and another 7 smaller banks were closed. The April 1998 operation differed from the November 1997 action in the following ways: (1) the existence of better arrangements for meeting depositors' claims and a professionally managed public relations campaign designed to calm the public; (2) an assurance that the interventions were based on uniform and transparent criteria and that no banks failing these criteria were excluded; (3) a full guarantee that covered all deposits, as well as all liabilities in other banks; and (4) the existence of a comprehensive banking sector strategy within which the operations were carried out. The failure to have all these elements in place in November 1997 was a major factor contributing to the deepening of the crisis. While the IMF alone was not responsible for this failure—since the unwillingness of the government at the highest level to back key parts of the strategy was also critical—it does point to important lessons (see also the discussion in the main report).

Many, including IMF staff, have increasingly come to accept the view that the decision not to install a blanket guarantee was the critical mistake of the November 1997 bank closure (Lindgren and others, 1999). However, the question of a blanket guarantee, particularly in the context of Indonesia,

[19]BI had an understanding that the 10 banks being rehabilitated would be closed if they did not demonstrate the capacity to become viable within six months to a year.

requires careful consideration.[20] In November, bank runs were associated with a shift of rupiah deposits from weak private banks to foreign banks, state banks (with an implicit guarantee), and some large private banks, with no decline in the assets of the banking sector as a whole. Large withdrawals from the banking system from the start of the crisis reflected the running down of foreign currency deposits.[21] It is only with the presidential succession crisis in May 1998 that the real value of rupiah deposits began to decline, owing to a loss of confidence in the banking system as a whole. At that time, the blanket guarantee could do little about the crisis of confidence in the entire economic and political system (Booth, 2001), let alone the ability of the government to honor that guarantee.

Deregulation

The need to reverse the creeping increase in rent-creating regulation over the past several years had been identified as a major issue by the World Bank and also in IMF surveillance. It was also on the agenda of the reformist economic team and had frequently been advocated by commentary in the local press. IMF management also viewed the program as an opportunity to assist the reformist team in pushing desirable reforms and the team viewed the program as providing leverage to do so.

Internal reports and interviews with staff indicate that, as the negotiations progressed in October 1997, the mission was under increasing pressure from Washington to include structural measures directed at dismantling the system that had given rise to extensive rent-seeking and cronyism in Indonesia. In part, this reflected the prevailing atmosphere of domestic politics in some of the major shareholder countries, where support was lacking for a large financing package without addressing the increasingly well-known governance issues in Indonesia.

Although several deregulation measures were included in the November program, a key feature of structural conditionality at this stage was the absence of both specificity and a clear timetable. Almost all agreed measures were general in nature and were to be implemented over the program's three-year lifespan. This provided the reformists with the necessary leverage to pursue reform but gave them discretion to push when and where they felt they could achieve results. This feature of the November structural conditionality, however, was not well understood by the public because, as was customary at the time, the LOI was not published.[22] Without access to the LOI, the public began to speculate on the content of structural conditionality in the November program. Given the press references to certain deregulation measures, this led to an excessive focus on governance-related measures in public debate.

The failure of the initial program, combined with frustration over the lack of progress in structural reform, led to increased emphasis on the need for reforms as a key element of the strategy to restore confidence. Some of the IMF's major shareholders pressed for greater specificity in structural conditionality. At the time of the Executive Board meeting on November 5, 1997, several Executive Directors had expressed their unhappiness with what they regarded as the vague and general nature of the structural conditionality, arguing that no progress would be likely in needed reforms without specificity and a clear timetable. The lack of progress in structural reform under the initial program reinforced their sense of misgiving.

This led to a much more specific and time-bound approach to structural conditionality in the January 1998 program. The World Bank's Jakarta-based staff took the lead role in drafting the structural conditionality for the January LOI, and the IMF team went out of its way to ensure that all concerns of the Bank were fully met. By this time, the Indonesian economic team had all but lost direct access to the President (Boediono, 2001). Negotiations were carried out directly with the President, at his own request. On the IMF side, the First Deputy Managing Director was personally engaged in finalizing the understandings with the President.

Contrary to what the IMF had expected, President Suharto did not openly oppose the expansion of structural conditionality or the inclusion of specific measures, including the cancellation of the National Car Project in which his son was involved. Indeed, President Suharto publicly signed the revised LOI in an attempt to indicate his commitment publicly. However,

[20] Some representatives of the Indonesian authorities told the evaluation team that they had not been adequately informed on this issue by the staff, especially regarding the blanket guarantee that had been provided in Thailand. Within the Indonesian government, however, the Ministry of Finance was adamantly opposed to a blanket guarantee on grounds of both equity and cost. In Washington, following criticism of the blanket guarantee in Thailand, there was strong opposition to establishing a blanket guarantee in Indonesia. Some former Executive Directors and U.S. government officials interviewed told the evaluation team, as a matter of their personal opinion, that a program for Indonesia would not have been approved by the Executive Board if the program had included a blanket guarantee.

[21] The balance of foreign currency deposits is estimated to have declined from about US$30 billion in August 1997 to about US$15 billion in June 1998.

[22] PDR, however, explicitly recommended that the IMF should learn from the mistakes made in Thailand and publish the LOI. The IMF thus sent an annotated version of the LOI suitable for publication to the authorities, who in turn agreed to make it public. However, it was never published.

the President's opposition was expressed in other ways. The President is reported to have said in a high-level meeting of his advisers that not all agreed measures needed to be respected, and that he would "wage a guerrilla war against the IMF." Later, he expressed the view that some of the reforms violated the Constitution. In February 1998, the staff reported in a memo to management that "all of the deregulation and liberalization measures relating to wood, cloves, BULOG, palm oil, wholesale and retail trade, and interregional trade [were] being subverted by various groups close to the President."

The inclusion of extensive governance-related structural measures in the IMF-supported programs with Indonesia has been widely criticized as having been counterproductive in dealing with a financial crisis (Feldstein, 1998). A former U.S. Federal Reserve Chairman, during his visit with the President in early January 1998, is reported to have criticized the structural conditionality as irrelevant to financial stabilization by facetiously calling the conditions on marketing deregulations in cloves, oranges, and other foodstuffs a "recipe" (Kenward, 2000; Blustein, 2001).[23] Likewise, a high-ranking Indonesian official remarked that "things might have turned out differently" if the conditionality had been confined to the macro-critical areas more relevant to dealing with the crisis, including comprehensive bank restructuring (Boediono, 2001).

In assessing these criticisms, it is important to recognize that structural conditionality became a seriously contentious issue only in January 1998. It was not the cause of the failure of the November program, which had more to do with the nonperformance of conditionality relating to bank restructuring and monetary control. In the wake of the collapse of the November 1997 program and the accelerated currency collapse in December, the IMF and officials of some key shareholder governments came to believe that more extensive structural conditionality was the only hope of restoring confidence by signaling a decisive break with the past, a view shared by some members of the academic community (Frankel, 2000; Goldstein, 2002) and the press (*Financial Times*, January 14, 1998).

The problems with the structural conditionality in the January 1998 LOI concern the lack of focus and ownership of the reform program, rather than its intrinsic usefulness to the Indonesian economy or the capacity to implement it. First, a number of the structural measures were popular with the public and did have beneficial effects on the economy when they were implemented. According to recent academic research, for example, the dismantling of monopolies and monopsonies, implemented from late January, substantially raised the farm-gate prices of major agricultural crops, and, as the IMF had hoped, helped minimize the adverse impact of the crisis on poverty (Montgomery and others, 2002). However, the program clearly did not benefit from ownership at the time it was announced and the ready perception of this lacuna made it completely ineffective. Second, the government's capacity certainly was not a binding constraint in the implementation of structural conditionality (Boediono, 2001). This is borne out by the fact that once the new Cabinet installed in March 1998 had convinced the President that there was no alternative to the IMF-supported program, the "50-point" program announced in January began to be implemented more fully.

The January LOI also failed to impress the markets because it did not simultaneously address the key macro-critical issues of bank and corporate debt restructuring. In this respect, the focus on extensive structural conditionality in areas outside the concern of the IMF can be said to have distracted attention from some core reforms that were indeed macro-critical.

Corporate debt restructuring

In early October 1997, before the negotiations began, PDR had expressed concern that uncertainty about the size of private sector short-term debt was not being addressed, and had suggested action on corporate debt, including the creation of a mechanism to identify firms needing assistance. However, because the IMF lacked expertise in this area, and given the optimism that the program would rapidly restore confidence, the IMF-supported program did not actively address the corporate debt issue until January 1998. The World Bank was also slow to get involved and it was only in the middle of 1998 that it began to assume a major role in supporting the dialogue between creditors and Indonesian conglomerates. The slow start on corporate debt restructuring partly stemmed from the authorities' view that the issue should be left largely to the private sector.

Starting in January 1998, the IMF provided technical assistance to a Private External Debt Team (PEDT). This had been set up in late 1997 as a voluntary initiative with the encouragement of the Indonesian authorities to provide a framework for the negotiations between creditors and corporations unable to service their debts. The role of the government was only indirect in this framework, and was limited to strengthening the legal and regulatory mechanism to enforce contracts. The debtors set up a

[23] At the suggestion of Singapore's Senior Minister, this former central banker was invited by President Suharto to provide an independent assessment of the IMF package. Kenward (2000) suspects that this negative assessment of the package may have influenced the President's subsequent actions.

committee to work with the PEDT but made it clear that little progress could be made without stronger government involvement, including financial support.

In the second half of March, a consensus emerged between creditors and the PEDT that some limited government involvement was necessary in the form of an exchange rate guarantee similar to that used in Mexico's so-called FICORCA scheme.[24] This position was endorsed by the IMF, with the caveat that there should be no subsidies to the corporate sector, a position shared by the authorities. The proposed voluntary approach aimed to protect debtors and creditors against exchange rate risk and to give assurance that foreign exchange would be available for debt-service payments in return for the restructuring of debt on specified minimum terms. Negotiations would seek to limit the exposure of the government to exchange rate risk.

In June 1998, adapting the FICORCA-type scheme to the conditions of Indonesia, a framework for the voluntary restructuring of debt was agreed in Frankfurt, and the Indonesia Debt Restructuring Agency (INDRA) was set up in August. Several problems remained, however. First, there was a need to reform the regulatory and legal framework, including removing restrictions on debt-to-equity conversions, eliminating tax disincentives for restructuring, streamlining approval procedures for FDI, a new arbitration law, and measures to provide for the registration of collateral. Second, the insurance provided by INDRA against further exchange rate depreciation was not attractive to many market participants, given the extent of exchange rate depreciation that had already occurred, for which market participants wanted some compensation. Third, as debt restructuring would take time, firms would remain short of working capital. Fourth, given the financial condition of many enterprises belonging to conglomerates, there were strong incentives for asset stripping by shifting assets to those entities better sheltered from the creditors.

On September 9, 1998, a "Jakarta Initiative" was finalized and became operational a month or two later. The initiative provided a framework to promote voluntary restructuring of debt through INDRA and to complement the amendments to the bankruptcy law aimed at providing incentives for debtors and creditors to negotiate. It included provisions for creditors to provide interim financing to distressed companies. Government involvement, however, was limited to the role of facilitator, including serving as a forum for the one-stop approval of regulatory filings. Despite all these initiatives, however, delays in implementing regulatory changes and difficulties in obtaining redress through the Indonesian legal system limited the progress of private sector debt restructuring. Well-placed interlocutors saw the failure to tackle the corporate debt issue as an important deficiency, as these debtors brought political pressure to bear on other issues. In this process, the IMF played a relatively limited role.

Initial strategy and its adaptation

Because the Indonesian crisis went through several phases, it is necessary not only to assess its conventional program design issues, but also to evaluate how effectively the IMF responded to emerging signs of failure and revised the initial program accordingly.

The initial strategy reflected the assumption that the crisis was a moderate case of contagion in which the rupiah had overshot. This view, which appears overly sanguine in retrospect, was widely shared by major market players at that time.[25] Market insiders interviewed told the evaluation team that some important hedge funds had in fact been betting in favor of the rupiah at the time the program was being negotiated, indicating their expectations that the IMF-supported program could work. The strategy, however, was a risky one and the staff recognized that if the basic assumption that the rupiah had overshot and could be nudged back to a more reasonable level was questioned, an entirely different approach would be necessary. However, the staff never explored what this alternative might imply.

In this regard, in the light of the Mexican experience, one Executive Director representing a major shareholder government encouraged the staff to have a fallback plan. There is no evidence, however, to suggest that the staff either prepared or discussed a contingency plan with the authorities. While it is not realistic to expect the IMF and the authorities to negotiate a comprehensive alternative strategy when time is short and the ability to take key political decisions is limited, it should have been possible to identify at an earlier stage more comprehensive measures to deal with a bankrupt corporate sector and a systemic banking crisis, both of which were quite likely outcomes.[26] In responding to emerging signs of failure in mid-November, the IMF was handicapped by the absence of an agreed fallback plan.

When the original program failed to restore confidence, the underlying assumptions of the strategy

[24]In the FICORCA scheme, creditors and debtors were provided a guarantee against further depreciation of the exchange rate from its value at the time the debt was restructured.

[25]See, for example, Goldman Sachs, "Emerging Markets Currency Analysis," November 1997.

[26]Indeed, the quite prescient memorandum from PDR in October 1997, referred to earlier, did call for such action.

needed to be reassessed. In the latter part of November, a mission was dispatched to assess the situation and to consult with the authorities. However, the mission's brief was largely focused on implementation within the logic of the original program and blamed the failure on nonimplementation. While the lack of implementation was undoubtedly part of the story, the original premises of the strategy were rapidly overtaken by events and there was a need for a more fundamental shift of strategy. The IMF's continued attempts to push the unwilling Indonesian economic team to raise interest rates led to a public display of disagreement, which was not helpful to building market confidence.

A critical oversight was the failure to follow up on the close monitoring of BLBI undertaken by staff in the field. IMF staff was monitoring liquidity support bank by bank on a daily basis and keeping senior staff at headquarters informed. However, the IMF did not immediately take a firm position on the issue. For example, it did not press the authorities on the staff's suggestion that BI should take control of banks receiving excessive support so as to prevent asset stripping. Given the culture of forbearance at BI and the lack of political support, little was done to contain the explosion of liquidity support. The IMF staff was prevented from knowing what was taking place within the recipient banks, particularly when collusion of some BI staff with bank owners was involved. Remedial action likely would have included a comprehensive intervention mechanism to deal with insolvent or illiquid banks, relying on the existing regulatory framework. In the event, it took the IMF staff four or five months to find out that corrupt and abusive practices were involved in the allocation of BLBI.

At the root of these problems was the lack of a fallback strategy to be pursued if the original somewhat sanguine assumption about an easy recovery of the rupiah proved misplaced. The IMF did revise the fiscal policy aspects of the program, but there was no reassessment of the underlying strategy itself. In particular, there was no comprehensive strategy to deal with the fundamental issues driving the crisis, namely, the collapsing banking and corporate sectors. While the issues were under constant review and various "Plan B" options were considered internally, existing differences of view within the IMF were not resolved until late January 1998.

In part, this delay reflected the lack of internationally accepted best practice in bank restructuring and the onset of a major crisis in Korea in late 1997, which took part of the attention and resources away from Indonesia. As a result, the IMF made a premature announcement of a package in mid-January, which focused heavily on deregulation and nonfinancial structural reform, but without including a comprehensive strategy to deal with banking system problem. With the benefit of hindsight, the signing of the second LOI should have been postponed for two weeks, to coincide with the announcement of comprehensive banking reform and corporate debt restructuring initiatives.

The Mode of Operations

This section discusses issues related to the IMF's mode of operations, including country ownership, the decision-making process, human resource management, and the role of major shareholders and collaboration with the World Bank and the ADB.

Country ownership

Indonesia poses a paradox regarding country ownership. Management took the view that the IMF should support the reformist economic team because they shared common views of economic policy. Moreover, most of the reform measures were almost universally applauded within Indonesia, except by a small number of powerful elites.[27] Nevertheless, the program failed because the key political authority, the President, did not buy into the reform process.

The IMF misjudged the commitment of the President and underestimated the pressures likely to come from his family and some of his influential associates. On several previous occasions, the economic team had received the full backing of the President to deal with economic crises and often successfully implemented the required reforms against opposition from powerful vested interests. With the increasing presence of the First Family and other competing stakeholders among the Indonesian elites, however, the economic team had lost much of that influence by the time of the crisis in 1997 (Booth, 2001). At the time of the crisis, this was well known to close observers of Indonesia.

The Indonesian economic team was very aware of its own limited influence in the country's decision-making process. In part, this was precisely the reason why the team needed the leverage of an IMF-supported program to implement the reforms. Knowing its limitations, the economic team also made sure to secure the personal commitment of the President to measures agreed in the IMF-supported program. One can only speculate what outcome would have resulted, had the President not received

[27]When the package of reforms was announced to the press in January 1998, Indonesian journalists spontaneously congratulated the IMF officials for their achievement.

the kind of opposition from his children and their close associates that he did in the last weeks of 1997, particularly following his illness in early December.

As it was, the program implied that firms and banks should be allowed to fail if they were insolvent. However, the President, under pressure from his children and close associates, was unwilling to let this happen. He also faced difficulty in allowing the structural reforms to go too far because they could undermine the very basis of his regime. According to some political observers interviewed by the evaluation team, the President wrongly came to view the IMF-supported program as an instrument of foreign powers seeking to undermine him.

How to secure ownership in such circumstances and what to do in its absence remains one of the unresolved issues arising from the Indonesian experience. To enhance ownership, the IMF did begin to recognize the need both to engage the President and to engage in a wider dialogue with various stakeholders. In January 1998, as noted, the First Deputy Managing Director visited Jakarta to negotiate directly with the President. Following the signing of the second LOI in mid-January, in which he himself participated, the Managing Director requested a retired member of management to serve as his personal representative to the President on an ongoing basis. The Indonesian team initiated conscientious efforts to talk to a wider group of people, both inside and outside the government. By then, however, the crisis had become largely political, overshadowing any consideration of ownership of economic policy.

Could a different approach have produced a better result? It is, of course, impossible to say. It could well be that no strategy would have been successful in separating the political and economic dimensions of the crisis. Nevertheless, a number of lessons on the ownership dimension do suggest themselves. First, an earlier assessment of the broader political economy issues underlying key elements of the program would have been useful. Second, a smaller set of structural measures that were fully owned could have reduced the scope for immediate implementation problems that damaged market confidence. Third, whatever the final judgments on ownership and the scope of the structural reform package, the January program should have included all of the measures judged macro-critical in order to be credible.

Decision-making process

In retrospect, it was probably a mistake to ignore the advice of PDR and the Resident Representative, and to rush the negotiation process in October 1997.[28] The decision to rush was understandable, given the prevailing perception of a major regional crisis in Southeast Asia. However, Indonesia still had sufficient foreign exchange reserves to last for several months, as indicated by the fact that the program included use of Indonesia's own reserves. The rushed procedure compromised quality in program design, particularly relating to the formulation of a comprehensive banking strategy and even possibly the assessment of insolvent banks, and prevented the IMF from fully benefiting from the safeguards of the internal review process. It is not possible to say whether a materially different assessment would have emerged from the established procedures.[29] With less pressure, however, the IMF could have given greater time to examine the full implications of each policy option being considered, including a fallback option.

The rushed procedure had additional consequences. Management often worked directly with the mission in the field, bypassing the safety mechanism inherent in a bureaucratic organization. Some senior review department officers told the evaluation team that they had often felt sidelined and excluded in the decision-making process. Moreover, the Executive Board became involved in day-to-day and very detailed aspects of the program negotiations through informal sessions. Along with communications especially from major shareholders, this subjected the staff to considerable political pressure.

By the end of November 1997, the IMF had an urgent need to make a fundamental reassessment of its strategy. However, the IMF's modus operandi, namely, short and intense country interactions, often with a pre-set and tight agenda, made it difficult for the staff to undertake such reassessment. Under the conditions prevailing in Indonesia at that time, the more permanent presence of a high-level team on the ground may have been beneficial as a mechanism for closely monitoring developments, providing timely policy advice and, if required, rapidly and smoothly modifying the strategy.

Human resource management

The Indonesian crisis, occurring as it did along with the other Asian crises, inevitably placed great strains on IMF resources and key decision makers

[28]PDR's comments on the brief included a proposal that a two-step approach of fact-finding followed by program design should be pursued. Likewise, the Resident Representative also advised strongly against rushing into a program, as it would unnecessarily panic the markets.

[29]For example, given the assumption that the exchange rate would quickly bounce back, use of BI's September data (available in early November) may not have given a substantially different diagnosis of the banking sector than did the June data, particularly because the staff was not allowed in any case to examine the loan files of individual banks.

within the institution. In many respects, the IMF responded very rapidly and with considerable flexibility. However, some aspects of the internal managerial approach, compounded by the IMF's modus operandi discussed above, did have an adverse impact on the effectiveness of the response. First, management took some time to reallocate human resources to APD, whose staff was overstretched by the simultaneous crises in Indonesia, Korea, and Thailand. When the Korean crisis erupted a few weeks after the Indonesian SBA was approved, more of management's attention and the institution's available human resources were shifted from Indonesia. Some senior staff members have indicated that the simultaneous pressures on resources probably contributed to the delay in the reformulation of the program from December 1997 to January 1998.

Second, APD took time to mobilize experts to the field. Even after a banking expert had been identified, it took months before he was formally assigned as a Resident Representative in Jakarta. This appointment was made in May 1998, over six months after the banking crisis had come into the open.

Third, available internal knowledge was not effectively used in formulating the program. Part of this was an unfortunate outcome of the reorganization of the Asia-Pacific operations of the IMF in early 1997.[30] The mission chief for the just-concluded 1997 Article IV consultation was not included in the mission that negotiated the program in October 1997 and had little input into the subsequent discussions on program formulation. Moreover, only a limited number of staff members of the first and subsequent APD missions had previous experience with Indonesia; the few with previous experience had not worked on the country for many years. This reflected a broader problem with excessive turnover of country teams within the IMF, as also noted in the IEO's evaluation of prolonged use of IMF resources (IEO, 2002).

Fourth, financial sector expertise was not fully shared within the missions. No one from MAE was a formal member of the negotiating mission, and the MAE technical assistance mission worked side-by-side with, but independently of, the APD mission. This arrangement was costly because the views of individual members of the MAE mission were not necessarily brought to the attention of the negotiating team.[31]

Fifth, there was little rationale for splitting responsibilities without defining clear lines of command in the staffing of the October 1997 mission, which was simultaneously headed by two mission chiefs. With a separate MAE mission, this meant the presence of three mission chiefs with different channels of communication with mission members and senior officers in Washington. Likewise, in February 1998, a decision was made to alternate two missions with two separate mission chiefs. This arrangement, which lasted only briefly from February to March 1998, was an understandable attempt to create a permanent high-level presence on the ground without creating the family and other personal pressure associated with permanent relocation at short notice. However, despite cooperation between the two teams, such an arrangement was not ideal in terms of maintaining continuity during a crisis. According to some of the mission members interviewed, the mission chiefs had slightly different points of emphasis, and the transfer of information from one team to the next was inevitably incomplete. Some Indonesian officials interviewed told the evaluation team that they had often needed to repeat the same information twice.

The role of major shareholders and collaboration with the World Bank and the ADB

Major shareholders and the Executive Board

Broad agreement existed on the strategy for Indonesia among most of the IMF's major shareholders who played an active role in the design of the program. Working through numerous informal sessions of the Executive Board, Executive Directors representing the major shareholders generally advocated tight fiscal and monetary policies and urged the adoption of structural reform measures aimed at improving governance. If there were dissenting views, they were not expressed at the formal Board meetings.[32] Once the depth of the recession became clear, however, the Board supported the loosening of fiscal policy.

Frequent informal sessions facilitated a flow of information between the staff and the Board. Execu-

[30]The Central Asia Department (CTA) and the South Asia and Pacific Department (SEA) were merged to form what is now APD, effective January 1, 1997. Staff coming from CTA, which previously had not covered the country, assumed the crisis management of Indonesia.

[31]The banking strategy announced in January 1998 was based on a January 13, 1998 memo prepared by a member of the MAE technical mission while the second LOI was being drafted. This memo was circulated to the negotiating mission late in the process and almost by chance. Perhaps a broader dialogue on banking sector ideas in October could have provoked an earlier formulation of the key elements of that strategy.

[32]Since the minutes of informal Board meetings are not kept, the evaluation team could only rely upon interviews with those present to ascertain what was said. There were also meetings of the Executive Directors for the G-7 countries, for which no minutes were kept.

tive Directors could not only receive information on rapidly changing developments at these meetings but also express their views relatively freely. While the dissemination of information may not have been perfect, the informal sessions nonetheless provided the Executive Directors with opportunities to voice their inputs into the program at different stages. However, detailed involvement by the Board in specific elements of program design probably went too far. Although it was appropriate for the Board to define the policies and principles to be applied to the IMF-supported program, the staff and management should have been given greater freedom to pursue a strategy based on their judgment of country ownership, technical merits, and political feasibility. Detailed involvement by the Board or a subgroup of major shareholders appears to have added to the pressures for an extensive list of detailed structural reform and deregulation measures in the January and April 1998 programs.

The World Bank

Management explicitly instructed staff to consult World Bank staff on program design, particularly regarding structural conditionality, and to cooperate closely in reviewing the financial condition of the banks. During the October 1997 mission, IMF staff was given a series of notes the Bank's Jakarta-based staff had prepared for the authorities during August and September 1997, advising them on how to deal with the crisis. The IMF staff also formally requested the World Bank for comments on the proposed content of conditionality but received no written response. However, some of the World Bank staff, including a senior official of its Jakarta office, felt that the IMF was not fully drawing on their resources and expertise.

Early difficulties between the IMF and World Bank teams in Jakarta in part resulted from the differences in the way the two institutions operate. IMF staff members involved in the negotiations said that they had initially found it difficult to work with Bank staff when tasks needed to be performed with tight deadlines since, in their view, the operational approach of the Bank often did not fit with such a timetable. Bank staff felt excluded because it was not informed of or invited to policy discussions. By January 1998, however, the working relationship had improved markedly, and the Bank's Jakarta team was fully involved in designing the structural conditionality of the revised program. Moreover, from late January 1998, the MAE team worked closely with its financial sector counterparts from the World Bank. World Bank staff participated fully, and was identified as co-authors in the series of reports prepared by the MAE staff during the crisis. As part of this close collaboration, the World Bank took the lead in the financing of the mid-1998 audits of the "IBRA banks."

Despite the active involvement of World Bank staff in much of the program negotiations and design, dissenting voices were heard from the Bank's Washington headquarters, and the Bank's Chief Economist publicly criticized the IMF-supported program. To deal with precisely this type of situation, the IMF and the World Bank had earlier agreed, in the so-called Concordat on Fund-Bank Collaboration prepared in March 1989, on a general procedure to resolve differences of view on economic issues. The Concordat stipulates a five-tiered procedure, starting with working level staff and ending at the Executive Boards; each additional tier comes into play only after best efforts to resolve differences have failed at the previous level. On an ad hoc basis, moreover, it envisages the possibility of establishing a study group, under the direction of the IMF's Director of Research and the Bank's Vice President, Development Economics, to examine analytical issues that may arise in areas of shared interest.[33] However, this procedure was not utilized to resolve the differences of view, in part because the differences did not follow a simple IMF-World Bank divide.

The ADB

The relationship with the ADB was also difficult. Its participation was initially conceived in the context of a technical assistance mission, given its earlier work on regional development banks. As a consequence, once a decision to negotiate a program was taken, the ADB's inputs, if any, were channeled through the MAE technical assistance mission. In addition to examining the balance sheets of regional development banks, the ADB was put in charge of looking at the nonbank financial institutions regulated by the Ministry of Finance, and not by BI.

Citing confidentiality, however, the IMF staff did not keep the ADB team fully informed of issues being discussed with the Indonesian authorities. The relationship was cool at best and continued to deteriorate until the end of January 1998, when the ADB temporarily pulled out of the collaborative relationship with the IMF over disagreement on the creation of the IBRA. The first ADB program loan, for US$1.4 bil-

[33]When the Concordat was discussed in the Executive Boards in 1989, however, the Bank's Executive Directors expressed serious reservations, so that the Bank did not consider it to be institutionally binding. More recently, in September 1998, the Managing Director of the IMF and the President of the World Bank issued a joint statement, reaffirming the principles underlying Fund-Bank collaboration as set out in the 1989 Concordat. See Boughton (2001), pp. 1003–05, 1055–61.

lion, was not approved until June 1998. Subsequently, working relationships were established again. ADB staff was involved in financial sector work with MAE, and took the lead in the audits of the "non-IBRA banks."

Conclusions

This section provides a summary of major findings and our assessment of the role of the IMF in the Indonesian crisis, as reviewed in this annex.

Precrisis surveillance

IMF surveillance of Indonesia in the precrisis period had limited effectiveness in terms of both diagnosis and impact. Although it identified the key issues, it did not emphasize the risks and assess comprehensively the impact if these risks were to materialize. The weaknesses of surveillance were particularly evident in the underestimation of governance problems in the banking sector, and the failure to analyze the implications of risks and corruption in an explicit and candid manner. Data weaknesses also hampered the effectiveness of surveillance, although a more systematic effort to analyze the potential vulnerabilities would have highlighted these weaknesses earlier.

Regarding the banking sector problems, the IMF identified the key issues but did not take a strong enough position, perhaps owing to the judgment that the weaknesses did not pose a systemic risk in an environment of strong macroeconomic growth. The IMF was not alone in this failure. In fact, even some of the closest observers had a generally positive assessment of the Indonesian banking system, while being well aware of pervasive corruption (Cole and Slade, 1996). The staff was handicapped by prevailing conventions that required it to approach governance issues with obliqueness. Moreover, banking sector issues were identified as part of technical assistance work, a voluntary process in which the IMF acts as the authorities' confidential advisor for their exclusive benefit. There was thus tension over how much of what was uncovered could be used to raise difficult questions during surveillance. Nevertheless, a more candid discussion of these issues in the Executive Board would have been helpful in highlighting the dangers of poor supervision, the moral hazard inherent in Indonesia's banking policy, and the urgency of dealing with insolvent banks while conditions remained favorable.

The lack of candor in discussing the implications of vulnerable balance sheets and pervasive corruption was another area of weakness in precrisis surveillance. As early as 1995, internal reviewers, especially those in RES, had pointed out that the adverse impact of a shift in market sentiment for the corporate sector and its macroeconomic consequences in an economy with a weak banking system, but these concerns were not pursued by exploring their implications.[34] As a result, the staff made only a limited attempt to collect data on corporate balance sheets.[35] While it is unlikely (and impossible to test) that greater candor would have led to a marked change in the authorities' policies, such a candid discussion would have allowed the IMF and the authorities to consider worst case scenarios in an atmosphere free of crisis.

The failure to present a candid analysis of the extent and nature of corruption in Indonesia led to unrealistic expectations about the ease with which reforms could be implemented and misled the IMF on the potential adverse short-run impact of the drive to deregulate. Corruption had always existed in Indonesia, but it did not prevent the economy from growing at an impressive rate over many years. This may have caused the IMF to overlook the changing nature of corruption in the 1990s, when both foreign and domestic investors began to focus on links to the Palace, rather than on the intrinsic economic merits of projects, in their investment decisions. By not openly discussing this aspect of the buoyant capital inflows, the IMF failed to perceive that Indonesia was particularly vulnerable to a sudden shift in investor confidence that might result, for example, from presidential succession concerns.

These weaknesses in part reflected a failure to take account of the wide range of views that might affect policy options and to grasp the broader political economy context within which presidential decisions were made. The surveillance dialogue placed too much faith in the ability of reformists to deliver policies, and failed to explicitly consider the various political constraints on policymaking. A focus on the reformist economic team was understandable. They had, after all, delivered important

[34]There is a striking parallel to what happened at the World Bank. According to the Country Assistance Note on Indonesia prepared by the Operations Evaluation Department (World Bank, 1999), in February 1997, the office of the Chief Economist "stressed that risk factors had been underestimated, that the Bank's strategy should not be limited to the optimistic base-case scenario, and that a 'downside analysis' was needed in view of the high country risks." According to this note, as late as August 20, 1997, Bank country staff and management downplayed these risks and communicated to the Executive Board that there was no cause for concern.

[35]The staff was aware of the importance of corporate debt restructuring. However, the few attempts made at corporate data collection were not sustained because of the inherent difficulty of obtaining such data as well as the perception that the corporate sector was outside the IMF mandate and in the purview of the World Bank.

policy corrections during earlier crises and the IMF clearly has to interact primarily with its official counterparts. Nevertheless, staff could have sought informal inputs from a much wider set of people in order to obtain a broader sense of the political constraints for economic reform. The Resident Representative, who had significant local knowledge, could have been better integrated into the surveillance process. In practice, surveillance was largely conducted, with short country visits, by IMF staff in Washington.

Program design and implementation

The November program was based on a critical assumption that the crisis was a moderate case of contagion and that a program of tight macroeconomic policies and banking reform, supported by foreign exchange market intervention, would succeed in restoring stability with only a temporary deceleration in growth. This proved grossly optimistic as the rupiah depreciated uncontrollably, owing initially to implementation failures and later to political developments. The initial assumption that the crisis would be easily controlled was at best fraught with risk, given the possibility of multiple equilibria. These risks were underestimated because the extent to which the crisis was a twin crisis, with severe weaknesses in the banking and corporate sectors, was not recognized early enough.

Given the initial highly optimistic assumptions on growth, *fiscal policy* was not inappropriate. One can argue in retrospect that, given the low initial level of public debt, it was misguided to include in the budget the carrying cost of bank restructuring, as the cost could have been financed by a slightly higher stock of debt over the medium term. However, the banking sector presented large contingent liabilities for the government, so that there was in fact less room than the formal public debt figures might have suggested for a massively countercyclical fiscal policy. Indonesia also faced the financing constraints resulting from the absence of a government bond market and the inherent difficulty of financing expenditures with issuance of debt during a crisis. In the case of Indonesia, the only recourse the government had to financing expenditure was drawing down its deposits at the central bank and foreign borrowing. Use of central bank deposits would have been counterproductive when base money was already exploding with liquidity support to the banking sector. Foreign borrowing was not an option when foreign lenders were fleeing from the country. Thus, while initial tightening was not necessary—and should not have been part of the program if a more realistic estimate of short-term growth prospects had been incorporated—there was little feasibility for a markedly expansionary fiscal policy.

As the crisis evolved, fiscal policy was continuously relaxed and the targets were never operationally binding. The fiscal program in 1998 also included adequate social considerations, as subsidies were increased on essential goods, while price increases were targeted toward goods and services consumed by higher income groups.

Monetary policy was never tightened during the early months of the program, despite the urgings of the IMF to the contrary. Most reasonable measures of real interest rates became increasingly negative, because the monetary base was expanding out of control with the provision of unlimited liquidity support to the collapsing banking system. As part of this support was used to fund capital flight, it placed downward pressure on the rupiah. Exchange rate and price stability only returned when monetary policy was tightened and nominal interest rates raised in the spring of 1998. In this respect, the adoption of base money targets, rather than conventional NDA targets, was not helpful as it allowed intervention and liquidity to get out of hand.

More generally, quarterly targets for any quantitative measure of base money (or its NDA component, for that matter) proved to be of little operational use in monitoring the conduct of monetary policy on a day-to-day basis during the crisis. Base money, consisting largely of the public's currency holdings, has a large endogenous component and is thus difficult to control in the short term, even under normal circumstances. During a banking crisis, base money is even more difficult to control, as there is a portfolio shift of unpredictable magnitude from deposits to currency. In the case of Indonesia, this difficulty was compounded by unlimited liquidity support, which caused base money to go out of control. A more direct discussion and explicit agreement on interest rate policy, as happened in the spring of 1998, along with a closer monitoring of the liquidity support operations, might have provided a better framework for monetary policy.

In this respect, a critical mistake in the initial strategy was to settle for an ill-defined "understanding" on interest rates without fully specifying what action would be required, given the unwillingness of the Indonesian economic team further to raise interest rates. This papering over of a fundamental disagreement about the appropriate approach subsequently led to a constant public display of disagreement between the IMF and the economic team, further damaging public confidence. The monetary policy the IMF advocated would have involved higher interest rates, and one can argue whether this would indeed have been appropriate, but the fact is that high interest rates were not applied.

The size of *financing* was based on conservative assumptions and may have appeared small in relation to the large capital outflows that took place. The IMF did not anticipate the magnitude of capital flight by local residents, but it is difficult to argue that the initial IMF-supported program should have been designed to take account of all such capital outflows. A number of staff members interviewed have argued that the relatively small amount of official financing available in the first few months of the program lowered the probability of success. However, in our view, shortage of financing was not the critical factor, especially since key aspects of the initial program were not implemented. Much of the capital flight that occurred can be attributed to political uncertainties, which were in turn exacerbated by the failure of the initial program. Additional official financing would not have helped to address any of the underlying issues and would have only allowed such flight to take place at a more appreciated exchange rate.

The initial design of *structural conditionality* in nonfinancial areas, mainly addressing governance issues, was reasonable, as almost all agreed measures were general in nature and were to be implemented over the three-year lifespan of the program. Structural reforms in nonfinancial areas became a contentious issue only in January 1998, when the initial program had failed and the crisis had turned political. By January 1998, key shareholders and the press no longer saw deregulation as just an issue of microeconomic inefficiency, but had begun to perceive the governance-related reforms as something necessary to restore confidence by signaling a clean break with the past. The extensive structural conditionality, a widely criticized feature of the IMF response, was not the cause of the failure of the initial program, but a response to it. While many of the measures were popular with the public and undoubtedly had beneficial effects on the economy, in retrospect, the extensive structural conditionality in the January 1998 program became a distraction from taking much needed action on bank and corporate debt restructuring, which was missing from the January program.

In *bank closure and restructuring,* there was no internationally accepted best practice at the onset of the Indonesian crisis. While the initial strategy of closing 16 banks was consistent with the program's logic (including the expectation of an exchange rate appreciation), it was based on a gross underestimation of the systemic nature of the banking sector problems. The IMF concluded that no other private banks needed to be intervened beyond the 10 under rehabilitation and the 16 being closed whose deposits represented only 3 percent of total banking sector assets, believing that the private banking system was sound beyond the troubled banks in the initial sample.[36] In retrospect, the mistake was not the closure of the 16 banks which was initially well received, but the absence of a comprehensive strategy to deal with insolvent or illiquid banks. Such a strategy was only introduced at the end of January 1998.

The question of the partial deposit guarantee in the November program requires careful consideration. Arguably, the amount of Rp 20 million was too small and should have been expanded to cover some legitimate institutional deposits. However, the concept of a partial guarantee was entirely reasonable in a corrupt banking system, where the well-connected insiders had benefited both from high deposit rates and from questionable lending practices. In the early months of the program, moreover, confidence was maintained in the banking sector, where state banks with an implicit government guarantee accounted for a large share. What was happening in November was a shift of deposits from those private banks that were perceived to be weak to state, foreign and larger private banks, so that the banking crisis was not yet systemic (in the sense of affecting the whole banking system).

In the end, the blanket guarantee enormously raised the fiscal cost of banking sector restructuring, which is now estimated at over 50 percent of GDP, and allowed the same insiders who had benefited from the system an additional way to profit from abusive and corrupt practices. Would the introduction of a blanket guarantee in November have halted the banking crisis? It is impossible to test such a counterfactual. However, the evidence discussed here suggests that the most damaging aspect of the November crisis was not the nature of the guarantee itself, but the lack a well-communicated, comprehensive strategy to deal with problem banks.

Finally, *corporate debt restructuring* was a missing element of the IMF-supported program. It started late and did not progress very far. Restructuring of corporate debt was a difficult process, particularly in a corrupt system lacking an adequate legal infrastructure. Even so, something could have been done early in the program, when Indonesia's corporate debt compared favorably with that of Korea, Thailand, and Brazil (Ghosh and others, 2002). If debt restructuring had been enforced with strong support of the President—clearly, a very big "if"—it might have gone a long way toward an equitable sharing of losses among various stakeholders, including the well connected, their foreign financiers, and the taxpaying public. In the end, the burden was almost entirely passed on to future generations through an increased stock of public debt.

[36]The staff knew that the state banks were in serious difficulty, but determined that they could more appropriately be dealt with separately.

The mode of operations

The failure of surveillance and weaknesses in program design and implementation in part reflected the IMF's mode of operations. The IMF overestimated the extent of country ownership, particularly in structural reforms. While most of the measures were endorsed by the economic team and popular with the general public, the program lacked the ownership of those who counted the most in the decision-making apparatus of Indonesia. Greater understanding of the political economy dynamics might have contributed to a different program design. Nevertheless, it must be recognized that separating the economic and political elements that made Indonesia's crisis so toxic would have been very difficult with any program.

The quality of program design was affected by the rushed procedure. While such a procedure may be necessary in certain cases, and the decision to rush was understandable under the conditions of great concern about a regional meltdown, the case of Indonesia—which initially had substantial reserves—does not seem to fall in that category. The rushed procedure led to detailed involvement by the Executive Board, subjecting the staff to greater political pressure. Management often worked directly with the missions in the field, bypassing the normal review mechanisms inherent in a bureaucratic organization. These problems were compounded by some weaknesses in human-resource management practices, which resulted in the failure to utilize available skills and resources in an efficient manner. The IMF showed flexibility in responding with speed, but there was a significant cost in terms of quality, especially in terms of understanding the nature of the crisis and the degree to which the program was owned and hence would be implemented.

Appendix A1.1

Indonesia: Selected Conditionality Under IMF-Supported Programs: Evolution and Implementation, 1997–98[1]

A. November 1997 Letter of Intent

Performance criteria	Benchmarks	Targets	Other conditions for completing the next review
End-December 1997 and end-March 1998 base money target.*	_By end-March 1998, introduce full tax deductibility of loan loss provisions._**	Commit to liberalize foreign trade and investment, including gradual phase out of export taxes and restrictions; dismantle monopolies and price controls; allow greater private sector participation in provision of infrastructure and privatization.	Finalize understandings for FY1998/99 and establish performance criteria (PC) for June and September 1998.[2] **
End-December 1997 and end-March 1998 overall central government balance to achieve surplus of ¾ percent of GDP for 1997/98 compared with 1.2 percent in 1996/97.*	By end-March 1998, complete public expenditure review.	Overall fiscal surplus of 1 percent of GDP for 1998/99 to be updated at time of first review.**	Update indicative targets to PC for 1998/99 budget and for end-June and end-September base money, net international reserves, and external debt.[2] **
End-December 1997 and end-March 1998 floor on net international reserves.**	_By end-March 1998, complete audits of state-owned banks by internationally recognized accounting firms._*	Reduce VAT exemptions from April 1998 and consolidate off-budget funds into budget within three years.**	_Limit use of Reforestation Fund to intended uses._
End-December 1997 and end-March 1998 limit on new external debt.**	By end-April 1998, reduce tariffs in line with ongoing 1995–2003 tariff reduction program.		Protect social spending and increase targeted aid to poor villages.
End-December 1997 and end-March 1998 limit on short-term debt outstanding.*	By end of program (in 2000) eliminate quantitative restrictions on trade.		
By end-December 1997, closure of "nursed" banks or those under conservatorship that do not submit rehabilitation plans or whose plans are not approved by BI.			
By end-December 1997, establishment of quantitative performance targets for state-owned banks together with monitoring mechanisms.			
By end-December 1997, issuance of implementation regulations on procurement and contracting procedures.			
By end-March 1998, 30 percent increase in electricity prices** _and petroleum prices raised to eliminate subsidies._ **d			

B. January 1998 MEFP and Letter of Intent

Prior actions	Performance criteria	Benchmarks	Targets	Other conditions for completing the next review
	By April 1998, begin to increase petroleum prices to eliminate subsidies with large initial rise (except for kerosene and diesel to protect the poor).**	By end-April 1998, reduce tariffs in line with commitments in October 1997 MEFP.	Avoid a decline in output, while containing inflation to 20 percent in 1998/99* and single digits in 1999/2000.	
	By end-March 1998, increase electricity prices by 30 percent.**		Overall fiscal deficit of about 1 percent of GDP for 1998/99.*	
	End-March 1998 base money target.		Accounts of Restoration and Investment Funds to be brought into budget in 1998/99.**	
	End-March 1998 overall central government balance to achieve deficit of 1 percent to 2 percent of GDP for 1997/98.		Twelve infrastructure projects to be canceled.**	
	End-March 1998 floor on net international reserves.		Budgetary and extrabudgetary support and credit privileges granted to IPTN's airplane projects to be discontinued, effective immediately.**d	
	End-March 1998 floor on new external debt.		All special tax, customs, and credit privileges for the National Car Project to be revoked, effective immediately.**d	
			Bank Indonesia to be given full autonomy to conduct monetary policy and to begin immediately to unilaterally decide interest rates on its SBI certificates.*	
			Virtually all of the restrictions that had been put in place over time to be eliminated. • From February 1, BULOG's monopoly over the import and distribution of sugar, as well as over the distribution of wheat flour, to be eliminated.** • Domestic trade in all agricultural products to be fully deregulated. • The Clove Marketing Board to be eliminated by June 1998. ** • All restrictive marketing arrangements to be abolished. Specifically, the cement, paper, and plywood cartels are to be dissolved.** • All formal and informal barriers to foreign investment in palm oil plantation and wholesale and retail trade to be lifted.**	

C. April 1998 Supplementary MEFP

Prior actions	Performance criteria	Benchmarks	Targets	Other conditions for completing the next review
Introduction of full tax deductibility of loan loss provisions (by end-March 1998). Transfer to IBRA control seven banks accounting for over 75 percent of BI liquidity support, and freeze licenses of seven other banks. Implement first stage increase in SBI interest rates (from 22 percent to 45 percent on March 23). Implement further increases in interest rates as necessary to strengthen the rupiah and to keep NDA in line with the program target. Keep NDA and base money in line with their program paths during the period before the Board meeting. Lift restrictions on foreign investment in wholesale trade. Raise prices of sugar, wheat flour, corn, soybean meal, and fishmeal. Identify seven new state enterprises to be privatized in 1998/99 (including steel, toll road, and coal mining companies; port and airport management companies; and a palm oil plantation). Extend to private sector subsidies on food items previously given only to BULOG (incomplete). Introduce resource rent tax on forestry products and reduce export tax on logs and sawn timber to 30 percent.	By end-June 1998, increase in prices of petroleum products to eliminate subsidies.** By end-June 1998, increase in electricity prices by 30 percent.** May 15, 1998 NDA; ** base money; * and liquidity support.*/* End-April 1998 overall central government balance to achieve deficit of 3.8 percent of GDP for 1997/98.*/* May 15, 1998 floor on net international reserves.*/* End-June ceiling 1998 on short-term external debt.*/* End-June ceiling 1998 on net external debt.** Merging Bank Bumi Daya and BAPINDO and transferring problem loans to the asset management unit of IBRA, by June 30, 1998.	By end-June 1998, audit state-owned banks by internationally recognized accounting firms (*). By end-June 1998, complete public expenditure review.	Monthly targets for end-May through June and quarterly targets through end-March 1999 for NDA;** base money;** liquidity support;** short-term external debt; * and NIR floor. **	By the end of September 1998; • Complete action plans for all 164 state enterprises.** • Initiate sales of additional shares in listed state enterprises including, at a minimum, the domestic and international telecommunications corporations. *** • Eliminate subsidies on sugar, wheat flour, corn, soybean meal, and fishmeal.**d • Complete divestiture of two state enterprises that are presently unlisted.* • Complete action plans for restructuring banks under auspices of IBRA.* By the end of December 1998: • Reduce export taxes on logs and sawn timber to 20 percent. • Complete audits of nonviable public enterprises. • Complete divestiture of two additional state enterprises that are presently unlisted. • Complete transfer of problem loans of IBRA banks to asset management unit.* • Submit to Parliament draft law on competition to prevent the abuse of dominant position and practices that restrict or distort free competition. By the end of March 1999: • Complete sales of additional shares in listed state enterprises. • Complete divestiture of three additional state enterprises that are presently unlisted.

C. April 1998 Supplementary MEFP *(concluded)*

Prior actions	Performance criteria	Benchmarks	Targets	Other conditions for completing the next review
Issue criteria for determining remaining locational restrictions on investment in palm oil plantations for environmental reasons.				• Restore IBRA banks to 8 percent capital adequacy ratio. • Prepare plans for privatization of at least one quarter of IBRA banks in 1999.
Make loan loss provisions fully tax deductible, after tax verification.				
Replace quantitative restrictions on palm oil, olein, and stearin with an export tax of no more than 40 percent.				
Announce dismantling of joint marketing body for plywood.				
Issue instructions to provincial governors to eliminate all local export taxes.				
Announce minimum capital requirements.				
Issue to IBRA an initial tranche of Rp 80 trillion in indexed government bonds.				
Enact government regulation in lieu of law to amend the Bankruptcy Law and establish a Special Commercial Court.				
Publish weekly key monetary data, including base money, NDA, and NIR.				
Provide historical data on the accounts of the Reforestation Fund.				

Note: Unless italicized, all the structural measures were included in the 1997 Article IV consultation report.

[1]*** = subject to revision during subsequent reviews; ** = fully satisfied conditionality without delay; **d = fully satisfied conditionality with delay; */* = partially satisfied conditionality; and * = unsatisfied conditionality. When no mark is attached information was considered insufficient to judge.

[2]PC for April and June 1998 were established.

Appendix A1.2

Indonesia: Timeline of Major Events[1]

Date	
7/9/97	IMF Executive Board meets for the 1997 Article IV consultation.[2]
7/11/97	The authorities widen rupiah trading band to 12 percent from 8 percent.
8/14/97	Indonesia abolishes its currency band and allows the currency to float. The rupiah falls to Rp 2,755 per U.S. dollar.
8/19/97	Central bank raises the one-month SBI rate to 30 percent from 11.625 percent.
8/29/97	BI governor announces limits on forward foreign currency trading by domestic banks to nonresident customers at US$5 million.
9/3/97	Reform measures introduced, including removing 49 percent limit on foreign investors' equity purchase for IPOs and raising luxury goods tax rate.
	Government announces delays for infrastructure projects of US$13 billion to curb widening current account deficit.
9/4/97	Central bank lowers the one-month SBI rate to 27 percent from 30 percent.
9/9/97	Central bank lowers the one-month SBI rate to 25 percent from 27 percent.
9/15/97	Central bank lowers the one-month SBI rate to 23 percent from 25 percent.
9/22/97	Central bank lowers the one-month SBI rate to 21 percent from 23 percent.
10/8/97	IMF sends a technical assistance mission on the financial sector and mission to discuss a three-year IMF-supported program.
10/20/97	Central bank lowers the one-month SBI interest rate to 20 percent from 21 percent.
10/31/97	IMF announces a US$23 billion financial package to help Indonesia stabilize its financial system.[2]
11/1/97	The government closes 16 banks. Guarantees payment of up to Rp 20 million per deposit starting November 13.
11/3/97	The rupiah strengthens by 7 percent following intervention by monetary authorities of Indonesia, Singapore, and Japan.
11/5/97	PT Bank Andromeda, part-owned by President Suharto's son, files lawsuit against Finance Minister and BI Governor challenging bank closure.
	IMF Executive Board approves 36-month Stand-By Arrangement for SDR 7.34 billion.[2]
11/7/97	Fifteen mega-projects quietly reinstated.
11/11/97	IMF Managing Director visits Jakarta.
11/23/97	The President's son buys a small bank and starts its banking business on the old premises of Bank Andromeda.
11/25/97	IMF mission arrives in Jakarta.
12/5/97	President Suharto begins an unprecedented 10-day rest at home.
12/12/97	President Suharto cancels a plan to attend the ASEAN summit in Kuala Lumpur.
12/23/97	President Suharto calls on a retired technocrat to help private companies deal with their debt crises.
12/30/97	The Jakarta court decides to delay the liquidation of PT Bank Jakarta owned by Suharto's half-brother Probosutedjo.
1/6/98	Rupiah falls 11 percent ahead of the budget announcement. President Suharto announces 32 percent increase in government spending for 1998/99, perceived as violating IMF targets.
1/8/98	Rupiah falls after comments by U.S. Deputy Treasury Secretary that Indonesia needs to show commitment to reform.
1/9/98	U.S. President Bill Clinton calls President Suharto to insist that IMF program must be followed.
1/13/98	The government is reported in local press to be considering introducing a currency board.
1/14/98	The rupiah rises 9 percent in expectation of an agreement on the IMF-supported package.
1/15/98	Rupiah loses 6 percent as President Suharto signs agreement to dismantle monopolies and family-owned businesses.
1/19/98	President Suharto emphasizes that National Car Project and plan to develop Indonesian jet plane will continue without state funding or assistance.
1/27/98	Government announces (i) full guarantee of commercial bank deposits and credits and new agency to restructure the banking sector, and (ii) "steering committee" to handle negotiations between foreign lenders and Indonesian debtors and freeze on debt payments pending new framework. There will be no debt moratorium since corporations must service debt if able to do so. Rupiah gains 18 percent.
	Central bank raises the one-month SBI rate to 22 percent from 20 percent.
2/11/98	Finance Minister says that Indonesia will soon establish a currency board and is finalizing the legal and institutional framework.
2/14/98	Fifty-four banks are brought under the auspices of IBRA and restrictions placed on their operations.
2/20/98	Government guarantees all deposits—Rp 3.1 trillion—in 16 liquidated banks. Previously covered up to Rp 20 million per account, totaling Rp 1.7 trillion.
2/22/98	Finance ministers from G-7 countries reportedly urge Indonesia to reconsider its plan for a currency board.

Indonesia: Timeline of Major Events *(concluded)*

Date	
3/2/98	President Suharto reports implementation of structural reforms under IMF program is incompatible with Indonesia's constitution.
3/3/98	Senior U.S. officials say the United States will not support the IMF's next loan disbursement without "adequate" progress in reforms.[3]
3/5/98	The European Union reportedly urges President Suharto to follow through the crisis with commitment to reforms under the IMF-led package.
3/10/98	President Suharto is reelected.
3/16/98	President Suharto's new cabinet sworn into office.
3/23/98	Central bank raises the one-month SBI rate to 45 percent from 22 percent.
4/4/98	IBRA takes over seven large banks with liquidity support exceeding Rp 2 trillion each and freezes licenses of seven small unsound banks.
4/8/98	IMF and Indonesia agree on new IMF-supported financial package that allows the government to maintain costly budget subsidies.[2]
4/21/98	Central bank raises the one-month SBI rate to 50 percent from 45 percent.
4/22/98	Economic Coordinating Minister says Indonesia implemented all the reforms due under deadline agreed with the IMF.
5/5/98	IMF Executive Board meeting approves US$1 billion loan disbursement to Indonesia. Board recommends tight monetary policy, strengthening banking restructuring, and providing a framework for addressing debt problems of private corporations.[2]
5/7/98	Central bank raises the one-month SBI rate to 58 percent from 50 percent.
5/21/98	President Suharto announces his resignation and immediately hands power over to Vice President B.J. Habibie.
5/22/98	President B.J. Habibie announces his cabinet, consisting of 23 ministers from the previous cabinet and 16 new appointees.
5/28/98	Bank of Central Asia put under IBRA control after massive run.
	IMF reportedly arranges meetings with Indonesian opposition leaders and activists in an effort to make ties across a broad spectrum.[3]
6/4/98	Indonesian debt negotiation team and creditor banks in Frankfurt agree on a comprehensive program to address Indonesia's external debt problem, including creation of an Indonesia Debt Restructuring Agency (INDRA).[3]
6/18/98	The Export-Import Bank of Japan announces that Japan signed US$1 billion trade credit facility for Indonesia.
6/24/98	Government signs another agreement with IMF, the fourth in nine months, promising further reforms.[2]
7/2/98	INDRA is established to tackle private debt problems.
7/15/98	IMF Executive Board meeting approves a US$1 billion loan disbursement.[2]
8/19/98	The one-month SBI rate reaches 70 percent after several rounds of increases over three months.
8/25/98	IMF Executive Board approves next credit tranche of US$1 billion and an Extended Fund Facility (EFF) arrangement for US$6.2 billion.[2]
9/23/98	Paris Club reschedules US$4.2 billion of sovereign debt.[3]

Sources: Bloomberg, Reuters, IMF, and local newspapers.
[1]Local time, unless noted otherwise.
[2]U.S. eastern standard time.
[3]Western European time.