

Indonesia's Pathway Through Financial Crisis

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Abstract

This article examines economic policymaking in Indonesia from the eve of the 1997 financial crisis to 2004 and asks whether engagement with the IMF widened or narrowed the choices available to Indonesian policymakers. It argues that engagement with the Fund expanded the menu of policy options available to the government when the IMF could count on a powerful internal champion that was ready to use its relationship with the Fund to strengthen its own position in the domestic political game. On the other hand, Fund's actions had the effect of constraining policy space during periods when the power of its internal champion was in decline, when a champion failed to materialize at all, or when trust between the Fund and the country authorities deteriorated rapidly.

This article examines Indonesia's pathway through the Asian financial crisis of 1997-98. The archipelago suffered by far the most traumatic experience of all the countries affected by the regional shock. Not only did Indonesia undergo the most severe economic contraction, it also experienced the worst political crisis, one that ended not only President Suharto's thirty-two years of rule, but also precipitated the collapse of an authoritarian, single-party political system. In addition, Indonesia engaged the IMF longer than any of the other countries affected by the crisis—Fund programs were not terminated until 2003, six years and four presidents after their launch in late 1997. Thus, Indonesia makes for particularly fertile ground to study the nexus between Fund programming and policy choices in a variety of political settings.

Rather than retelling the story of Indonesia's financial collapse and economic reconstruction—a story already recounted in a large and still-growing literature—I provide an account of Indonesia's pathway through crisis as seen through the lens of “policy space”. I focus, following Woods in her introduction to this issue, on whether engagement with the IMF widened or narrowed the choices available to Indonesian policymakers. I also examine how the Fund's position was itself affected by changes in policy space.

The piece makes two arguments. First, it contends that the Indonesian government's engagement with the Fund expanded the menu of policy options available to policymakers when the IMF could count on a powerful internal champion within government, a champion that was ready to use its relationship with the Fund to strengthen its own position in the domestic political game. On the other hand, Fund's actions had the effect of constraining policy space during periods when the power of its internal champion was in decline, when a champion failed to materialize at all, or when trust between the Fund and the country authorities deteriorated rapidly. In these cases, the Fund was far more likely to use its leverage to block the government's independent policy initiatives. In addition, the article suggests that just because a government may be highly-centralized and insulated from social pressures, it does not follow that it will be highly effective at implementing IMF conditionality or, on the other hand, that it will inevitably be a source of chronic policy volatility.

The article will unfold as follows. First, I provide a brief discussion of the notion of “policy space” and propose a way to conceptualize it. I then explain the central dynamics of economic policymaking in Indonesia and describe the evolution of the relationship between the Indonesian government and the IMF from the 1960s to the eve of the 1997 crisis. The fourth section, which constitutes the bulk of the article, analyzes the impact of Fund programming on policy space in Indonesia in the period from 1996 to 2004. The last section concludes.

Conceptualizing policy space

The concept of policy space is often invoked in political discourse, but its meaning is rarely defined clearly. Currently, policy space is most often used in debates about how certain rules in the global economy—particularly those emanating from the WTO and its subsidiary agreements—constrain countries' policy options for medium- and long-term economic development. For example, Birdsall, Rodrik, and Subramanian talk about the need for poor countries to have “enough space to craft their own economic policy” and “adequate room for

policy autonomy and experimentation”.¹ Wade writes of “development space”, by which he means the freedom of developing countries to pursue, among other things, the kinds of development policies used in the past by what today are the world’s advanced economies.² Meanwhile, the United Nations Trade and Development Programme (UNCTAD), which devoted much attention to the idea in its 2004 annual conference, conceptualized policy space as a fusion of the principle of sovereign equality among sovereign states, the right to development, and the principle of special treatment for developing countries.³

But if we are to use the notion of policy space to analyze the impact of IMF programs on the choices of developing countries, the concept needs to be adapted in two ways. First, because governments typically engage the Fund during crises requiring immediate action, and because the IMF works through relatively short-term policy instruments, policy space must admit not only long-term development policies, but also short-term, crisis-management initiatives. For this reason, I define policy space simply as the menu of economic-policy options believed by policymakers to be available to them at a certain point in time. Of course, the state is not monolithic, and “policymakers” generally does not refer to a homogenous group. Thus, for the purposes of this paper, I look at policy space from the perspective of the most important political factions competing to shape economic policy.

Second, we are interested not only in the length and content of the policy menu, but also in the *process* through which that menu is generated and policies are selected from it. Therefore, there ought to be a second dimension to the concept of policy space; it should also capture the number of actors that can participate in the process of political contestation in a particular policy area.

Economic policymaking in Indonesia

As a number of scholars have pointed out, the dynamics of economic policymaking in Indonesia before 1997 are best understood as a struggle among three groups to influence President Suharto, who was the final policy arbiter in a centralized and authoritarian, if nominally democratic, regime.⁴ The first group was composed of academic economists-turned-policymakers, the “technocrats”, who favored a liberal, market-oriented economy.⁵ Plucked from academia in the mid-1960s to help Suharto stabilize the economy, these officials sat atop the key economic ministries for most of his 32-year rule and were the government’s primary interface with the international financial institutions.

The second and more heterogeneous group usually falls under rubrics such as “nationalists” and “technologists”. Including cabinet members from key spending ministries and some senior military officers, the nationalists generally favored an activist role for the state in protecting industry and allocating capital, usually to the benefit of *pribumi* (“native” Indonesian, rather than Chinese-Indonesian) entrepreneurs. The third group, which became especially prominent in the 1990s, was composed of “cronies”, who included large entrepreneurs close to the president, as well as Suharto’s children and their close associates.

Although formally in charge of economic policymaking and ensconced in the top echelons of government for the better part of three decades, the technocrats' policy influence was highly variable and depended on the economic context. The technocrats were few in number and had no base of support within government and no constituency outside it. Indeed, their relationship to the international financial institutions and to "the markets"—a link they constantly played up—was their only link to external support. The president trusted the technocrats primarily as expert crisis-managers and economic fixers, which meant that their clout peaked during times of economic turmoil. But during times of relative stability and prosperity, nationalist and crony interests tended to dominate policy, and during these times there was little the technocrats could do other than try to curb some of these groups' worst excesses before they could jeopardize fiscal and monetary stability.⁶

Acutely conscious of their context-dependent influence, over time the technocrats became keenly attuned to post-crisis windows of opportunity, and they worked hard to capitalize on these politically auspicious but finite moments of influence. Fortunately for the technocrats, Suharto was a pragmatic man, not wedded to ideology and willing to revise his assumptions and experiment with innovative policies.⁷ But as his regime entered the 1990s, the president became increasingly reluctant to make decisions that harmed the interests of his relatives and close associates.

Indonesia and the IMF

Indonesia's relations with the IMF date back to 1966. Having ousted his predecessor in a military coup in 1965, General Suharto inherited an economy in chaos, plagued by hyperinflation and cut off from international financing. In December 1966, Indonesia's official creditors agreed to reschedule debt payments, and the new government committed to reducing barriers to trade and foreign investment, among other things.⁸ The measures were monitored and assisted by the IMF, which designed the macroeconomic-stabilization plan. The experience restored Indonesia's ties with the Bretton Woods institutions, links which had been severed after Sukarno's alignment with Moscow and after his famous declaration to Western donors: "Go to hell with your aid". In February 1967, Indonesia formally re-joined the Fund's membership.

After Suharto's economic team proved adept at controlling inflation and restoring fiscal balance in the early 1970s, the technocrats adopted a staunchly independent attitude vis-à-vis the Bretton Woods institutions. Indonesia received its last IMF stand-by loan before the late 1990s in 1970; after that, the Indonesians only made use of the Fund's Compensatory Financing Facility (CFF) in years of falling commodity prices.⁹ In the 1980s, the Indonesians designed and implemented their own economic reforms, ignoring, for example, the Fund's advice not to open the capital account before liberalizing trade and engaging in more extensive banking-sector deregulation than the Fund recommended.¹⁰ The officials also became, in the words of a prominent technocrat, "allergic to IMF standbys"¹¹, and chose to deal with fiscal shocks in 1983 and 1986-87 through homemade, rather than through IMF-designed, stabilization plans. Indonesia's interaction with the Fund during these years was limited to annual Article IV consultations and technical assistance on monetary issues.

While zealously guarding their autonomy, Indonesian policymakers nevertheless consulted regularly members of the Fund and Bank's Jakarta staff, who were seen as "good intellectual sparring partners".¹² Relations with the World Bank were especially strong, as the technocrats found its expertise in trade and financial liberalization more relevant to their reform plans than the Fund's macroeconomic specialties. The fact that Suharto's economic team shared (and in its liberalism sometimes surpassed) the orthodox views of the Bretton Woods institutions clearly helped to build good working relations. By the 1990s, then, a cordial but arms-length relationship had developed between the Indonesian economic team and the IMF, one that relied heavily on the permanence of the technocrats in government.

The causes and consequences of Indonesia's financial crisis have been extensively discussed elsewhere.¹³ Here, I limit myself to recounting the facts that led to renewed engagement with the IMF in the 1990s. A series of factors including rapid financial deregulation, weak regulatory institutions, and corporate structures that encouraged excessive risk-taking rendered the Indonesian economy highly vulnerable to interest- and exchange-rate shocks. After Thai monetary authorities abandoned their pegged exchange in the spring of 1997, investors lost confidence that pegged exchange rates could be maintained in countries with similar characteristics, including Indonesia. A massive sell-offs of assets denominated in Asian currencies, including the Indonesian rupiah, ensued. After a brief defense of the peg, the Indonesian central bank, Bank Indonesia (BI), let the rupiah float (or sink) on August 14. Between July and October 1997 the currency depreciated by 34 percent.¹⁴ The currency crisis soon became a banking crisis, and Bank Indonesia intervened in the banking system, controversially injecting billions of rupiah to prop up troubled financial institutions.¹⁵

In early October, thinking that a precautionary arrangement would restore Indonesia's credibility and protect the currency from further decline, the Indonesian government approached the IMF, but it soon became clear that only stronger medicine, in the form of a stand-by arrangement, would have a chance of restoring confidence. By the end of the month, the Fund had extended a stand-by arrangement giving Jakarta access to as much as US\$11.4 billion in emergency assistance. This was part of a larger international package for Indonesia amounting to some US\$18 billion.¹⁶ Thus began Indonesia's intense, and occasionally turbulent, six-year-long relationship with the IMF. This relationship would be structured by three programs—one stand-by arrangement and two arrangements drawing on the IMF's Extended Fund Facility (EFF). The table below shows the resource flows between the Indonesian treasury and the IMF from the crisis to the present.

Table 1. Indonesia's transactions with the IMF, 1997-2006 (US\$ million)

Program*	Year	Disbursements	Repurchases	Charges and Interest Paid
Stand-by arrangement	1997	2,201.47	0	0
	1998	4,254.35	0	133.96
1 st Extended Fund Facility arrangement	1999	1,011.00	0	267.54
	2000	851.15	0	398.85
2 nd Extended Fund Facility arrangement	2001	309.65	1,375.92	369.50
	2002	1,100.96	1,834.56	202.86
	2003	1,376.24	979.26	148.64
Post-program monitoring	2004	0	678.07	172.25
	2005	0	774.81	211.82
	2006	0	273.42**	59.91**

* Indonesia's stand-by arrangement with the Fund ran from November 5, 1997 to August 25, 1998, the first Extended Fund Facility arrangement ran from the end of the stand-by to February 4, 2000, and the last EFF arrangement ran from February 2000 to December 31, 2003.

** As of April 30, 2006

Source: "Indonesia: Financial Position with the Fund", IMF website.

Assessing policy space

How can we assess whether the Indonesian government's engagement with the Fund expanded or contracted its policy space? The approach I propose here is to examine the evolution of Indonesian economic policy over the course of the three IMF programs, looking for changes in both dimensions of policy space as defined above. To assess changes in "policy space as menu of options", we should ask whether the range of choices Indonesian policymakers believed to be available to them expanded or contracted over time as manifested in their commitments with the Fund, their public statements, and their policy deliberations and decisions, including policies adopted as well as those abandoned. Because it is neither possible nor practical to look at *all* economic policies deemed viable, I focus on a subset of key policy areas, namely, monetary, exchange-rate, trade, and fiscal policies, as well as banking regulation. In terms of assessing "policy space as room for contestation", I focus on whether the rules of the political allowed new domestic actors could enter the arena of economic policymaking.

This technique allows us to divide the period starting on the eve of the crisis in 1996 and ending a year after the Fund programs were terminated in 2004 into six distinct periods, based on whether "policy space as menu of options" was contracting or expanding, and whether "policy space as room for contestation" was closed or open. The periodization is summarized in the table below.

Table 2. Changes in two dimensions of policy space, 1996-2004

Policy space as universe of policy options	Expanding	Period 2: Technocrats to the rescue (Aug 1997 – Jan 1998) Period 4: Habibie’s crisis management (June 1998 - Oct 1999)	Period 6: Life after the IMF (Aug 2002 -)
	Contracting	Period 1: Late New-Order cronyism (1996 - July 1997) Period 3: Suharto’s guerilla war (Feb - May 1998)	Period 5: Democratic transition and fragmentation (Nov 1999 - July 2002)
		Closed	Open
		Policy space as room for contestation	

As the table shows, there were three significant shifts in “policy space as menu of options” from the eve of the crisis to the end of the second year of the IMF programs. During this time, the policy arena remained closed, with executive power still at the center of decision-making and policy shaped by the traditional struggle between technocrats, nationalists, and cronies vying for presidential support. In period (4), however, the political arena was beginning to open as the country began its transition to democracy. After that, events in periods (5) and (6) unfolded in what can only be described as open policy space, with new players, particularly the legislature (DPR), the press, and civil society, entering the policy arena as active participants. In that context, we see one further shift in policy space as menu of options. In the rest of the paper, I describe how I arrived at this periodization and discuss its implications.

Period 1: Late New-Order cronyism

The initial position in this exercise is located a year before the currency crisis broke in August 1997. These were the last months of the New Order, as Suharto’s regime was known. Since at least 1990, policymaking under the New Order had been characterized by the capture of state policy in key economic areas by a very narrow set of interests tied directly to the presidential palace. The first half of the 1990s had been years of strong economic growth, massive inflows of foreign investment, and a boom in bank lending—the kind of economic conditions that traditionally strengthened cronies and nationalists and marginalized technocrats. This meant that large areas of economic policy were effectively closed to would-be reformers, and from the point of view of the technocrats, lasting economic reform could only be undertaken if these areas were opened. “Our frustration,” said leading technocrat Ali Wardhana in 1993, “is

that we have control over part of the game but we can't win the game unless other parts play along."¹⁷

To be sure, the technocrats were in control of exchange-rate policy and to a large degree of monetary policy, but important elements of banking regulation, trade policy, and fiscal policy, were not open to discussion. In banking regulation, the central bank was unable to close banks it deemed insolvent because of political interference. In 1996 and again in April 1997, BI's governor recommended to President Suharto that seven insolvent banks be closed immediately, but the president delayed these closures until November 1997; by then, the crisis had already engulfed the banking sector.¹⁸ Also, regulators who interfered with politically-connected banks were removed or otherwise hindered from carrying out their tasks.¹⁹

In terms of trade policy, a wide scope of formal and informal measures was in place to guarantee the flow of rents to Suharto's associates and relatives. These included not only tariff protection, but also export restrictions and exclusive marketing arrangements on a variety of commodities, including two of Indonesia's leading exports—cloves and plywood. These private monopolies granted by the president to members of his inner circle effectively made the monopolists more powerful than the state authorities that were supposed to regulate them.²⁰ Finally, some aspects of fiscal policy were also untouchable, including the use of central bank and budgetary funds to finance large infrastructure projects managed by Suharto's six children and cronies.²¹

Period 2: Technocrats to the rescue

As economic conditions deteriorated rapidly in September of 1997, Suharto's technocrats initially believed confidence could be restored with something less than a full standby agreement with the IMF. BI Governor Djwandono was convinced that Indonesia did not require full IMF assistance because the central bank still had around four months' worth of exports in reserve capital.²² However, by the time negotiations with the Fund were well advanced in late October, it was clear that only a full-fledged IMF program had a chance of restoring market confidence in Indonesia's course. The economic team signed the first letter of intent (LOI) with the Fund on October 31, 1997 and a second one on January 15, 1998. The latter included over 50 action points and would later become a poster-child for those criticizing the IMF's conditionality excesses in the 1990s.

At some point between early October and January, the technocrats and their World Bank colleagues—with whom they had been working on a reform agenda for years—realized that the IMF program could be used to overcome resistance from powerful groups and implement structural reforms they had long considered necessary. The introduction of a structural-reform wish list into the LOIs seems to have been driven more forcefully by the World Bank's staff than by the technocrats themselves, but the Indonesians were clearly in favor of using this window of opportunity to advance the reform process.²³ A Bank document put it this way: "Ironically, the crisis provided an opportunity for the Bank to get action on many of the necessary structural changes. By January 1998, Bank staff had managed to incorporate into the IMF programs most of the reforms it wanted."²⁴

During this period, the technocrats were at the peak of their policy influence in government and were very much in charge of the crisis-management efforts. Suharto had full confidence in the team that had solved many crises before, and he gave the group free rein to negotiate with the Fund, at least in October 1997. Meanwhile, the IMF was happy to help, and saw its role as providing the technocrats with the political leverage they needed. According to the Fund, “IMF management...viewed the program as an opportunity to assist the reformist team in pushing desirable reforms and the [IMF] team viewed the program as providing leverage to do so.”²⁵

The effect of the two Letters of Intent was to expand very significantly the menu of policies Indonesian policymakers thought were available to them. Formerly taboo issues in banking regulation and trade and fiscal policy suddenly appeared open to reform. The IMF program required, among other things, the immediate closure of 16 insolvent banks; the phasing out of monopolies in certain commodities, including cloves and plywood; the immediate lifting of non-tariff barriers on wheat flour, soybeans, and garlic; the suspension of large infrastructure projects; and the opening of closed sectors to foreign direct investment, including banking. In short, engagement with the IMF, with extensive support from the World Bank, significantly expanded the Indonesian government’s policy space at this juncture.

Period 3: Suharto’s guerilla war

Surprisingly, President Suharto had not objected to the extensive provisions outlined in the January 15 LOI, including those that directly undermined the interests of his relatives and associates. However, he soon signaled that he did not intend to comply, famously announcing that he would wage a “guerilla war” against the IMF, and the groups most affected by the proposed IMF reforms soon followed their leader. Before the ink was dry on the January LOI, it became clear that many of the policies supposedly made possible by the IMF program could not be implemented. Infrastructure projects cancelled under the LOIs were restarted under presidential orders, and one of the closed banks belonging to a Suharto relative was reopened under a different name. Also, despite government attempts to disband the plywood and clove monopolies, crafty vehicles were found to keep them functioning.

Meanwhile, the technocrats’ influence and control over economic policy began to decline precipitously. This waning began when the president insisted on negotiating the January LOI himself, with the technocrats in the background. He also formed a new Committee for Economic and Financial Resilience, which diluted technocratic influence by adding nationalists from the cabinet and two businessmen as top economic advisors to the president. In addition, Suharto replaced his minister of finance with a former IMF deputy managing director, Prabhakar Narvekar, as his chief interlocutor with the IMF. In February, BI Governor Djwandono was dismissed, and the finance minister and the coordinating minister of the economy—both prominent technocrats—would be replaced with staunch nationalists and prominent cronies in March.²⁶

The Fund was particularly vulnerable to the technocrats’ political demise at this stage for two reasons. First, the Fund’s presence on the ground before and during the crisis was thin, and the turnover in IMF missions was high; this meant that the Fund was highly dependent on the

technocrats (and also on the World Bank's Jakarta staff) for information, expertise, and political access. Second, fairly or unfairly, much of the blame for the botched bank closures of November 1997 and for what was seen as excessively tight monetary policy in late 1997 fell on the IMF. These alleged policy errors, compounded by bad public-relations management, damaged the Fund's reputation in Indonesian public opinion so badly its credibility never fully recovered. With the public alienated and with Indonesian elites increasingly regarding the IMF as a political liability, the downfall of the Fund's internal champion in early 1998 proved doubly damaging.

Suharto, desperate to stabilize the economy before his scheduled re-election, announced on March 1st an alternative course of action he called "IMF-plus", which included the possible adoption of a currency board arrangement. The currency board option, which would have marked a radical departure from the Fund's recommended exchange-rate policy, was announced without previous consultations with either the technocrats or the IMF. Adamantly opposed to the currency board, but with its internal champions badly weakened, the Fund turned to a more coercive approach. In a letter to President Suharto, Managing Director Michel Camdessus threatened to withdraw financial support if the currency board proposal was implemented.²⁷ Suharto also received calls or visits from several G7 heads of state, including President Bill Clinton, urging him to stick to the IMF program and drop the currency board project.²⁸ The disbursement of US\$3 billion due on March 15 was also put on hold until there was evidence of better compliance. The currency board proposal was subsequently abandoned.

In sum, this period saw the menu of options available to the government contract in two ways. First, it became clear that the policy areas outlined in the LOIs, would not be opened so easily, as the groups affected could effectively undermine policy change. In addition, the Fund and its top shareholders exerted strong pressure to block the president from undertaking independent policy initiatives once the technocrats lost their influence.

Period 4: Habibie's crisis management

The economic crisis soon sparked ethnic conflict and social violence that would leave more than one thousand people dead by the end of May 1998.²⁹ Having lost the support of the political elite and the military, Suharto resigned on May 21, leaving Vice-President B.J. Habibie in charge. Nor surprisingly, Habibie's hold on power was seen as illegitimate by the pro-democracy *Reformasi* movement, and he also faced challengers within his own party. Consequently, the new president's main priorities during his 16-month administration were to ensure his political survival and to control the terms of the country's transition to democracy.³⁰ This meant stabilizing the economy first, and Habibie was willing to use to IMF blueprint to do it.

Habibie's survival imperative led him to improve quickly relations with the Fund. A new letter of intent was signed on July 29 reaffirming the government's commitments made under previous LOIs and adding new provisions on banking and corporate restructuring. Although the old technocrats did not stage a comeback under Habibie (only one remained in the cabinet), the Coordinating Minister of the Economy Ginandjar Kartasasmita, known as a "nationalist" figure, would become an effective and trusted interlocutor between the government and the IMF. This

suggests that while the technocrats had been the Fund's internal champions, they were not indispensable for good working relations between the institution and the government.

The policy arena under Habibie remained closed, giving the Executive exclusive control of policymaking, and the new government's relative cohesion gave it more space for new policy initiatives, albeit within the parameters of the IMF program. Serious political opposition to Habibie failed to materialize, and the president succeeded in setting his preferred electoral calendar, which included an indirect presidential election in October 1999. Crucially, Habibie retained firm control of his party, Golkar, which still commanded a majority in the legislature; this gave the president considerable power to make and implement policy. A member of the Habibie cabinet put it this way: "The Habibie era was a short but highly unusual period. In retrospect,...it was a time when the Fund-supported program actually stood the best chance for its full implementation. It was a period when the ownership of the program was strongest while the implementation capacity of the New Order remained more or less intact."³¹

These conditions allowed the government to push ahead with the reforms initially introduced by the Fund programs. The 1992 Banking Act was amended, opening the long-protected banking sector to foreign ownership, and a new central bank law was introduced, giving Bank Indonesia statutory independence. Both of these measures were contained in the LOIs and would have been hard to imagine under the New Order, given the high level of political interference in credit allocation and bank regulation. Unlike bank closures under Suharto, the closure or takeover of 46 banks in March 1999 took place without political interference, and meanwhile, powerful business figures were being dragged before IBRA, the bank-restructuring agency, and forced to account for their debts and for the misuse of central bank liquidity support.

In addition to key changes to the country's electoral rules, the government also presided over the passage of two laws that redefined fiscal relations between the central government and sub-national governments. Unlike the central bank law, the decentralization laws were homemade and were not part of the LOIs, suggesting that the government retained some room for policy experimentation despite the IMF program.

The end of the Habibie administration was marred by a corruption scandal (known as Bank Bali) and the bloody secession of East Timor. These issues led the IMF to suspend disbursement of a tranche due in September 1999, just before the presidential elections. The two events ruined Habibie's reelection prospects, and the Bank Bali scandal revealed that New-Order-style corruption was still operating beneath the surface.

Period 5: Democratic transition and paralysis

President Abdurrahman Wahid was indirectly elected in October 1999 after extensive bargaining among political parties, opening a period in Indonesian politics characterized by increasing political competition and democracy, but also by fragmentation and policy paralysis. This meant that as Indonesia's "policy space as room for contestation" opened, the menu of options available to policymakers contracted.

Two kinds of fragmentation afflicted economic policymaking during this period. First, Wahid's economic cabinet was fragmented across party lines, which inhibited cooperation. It did not help that the president set up his own board of economic advisors, the *Dewan Ekonomi Nasional*, (DEN), and then, instead of having the body report directly to him, he encouraged DEN experts to take their policy ideas directly to the ministers, who were naturally reluctant to take outside advice.³² Second, a chasm opened between the executive and the legislature, as the latter asserted its new-found power in Indonesian politics. For the first time, the president's party no longer controlled a majority in the legislature, and conflict between president and parliament would escalate and culminate in the impeachment and removal of President Wahid in July 2001. The press, emancipated during Habibie's administration, added fuel to the political fire with its extensive coverage of political intrigue, rumor, and corruption. In the face of the uncertainty generated about the direction of the reform process, the bureaucracy under President Wahid neared paralysis.³³

While the government's capacity to formulate and implement economic policy declined, relations with the Fund deteriorated dramatically. Wahid's choice of "nationalist" figures to head the economic cabinet (Kwik Kian Gie and Rizal Ramli)—both of whom adopted confrontational stances vis-à-vis the IMF—seriously strained the relationship with the Fund and led to a breakdown of trust. This led the Fund to adopt a more coercive stance and a heavier dose of micro-management. It also focused more intensely on governance reform.

Not surprisingly, the first LOI under the Wahid government, signed in January 2000, was unusually long and detailed, specifying details for policy implementation in financial governance, corporate and bank restructuring, and privatization. Unable or unwilling to trust government agencies, the Fund called for the creation of independent bodies to supervise policy implantation at both the central bank and the bank-restructuring agency.³⁴ When the legislature announced plans to amend the 1999 Central Bank Law, the Fund objected strongly, threatening to withhold its next disbursement if the amendments jeopardized the central bank independence.³⁵ In total, clashes over the central bank amendments and over fiscal policy led the IMF to delay disbursements to Indonesia from December 2000 until September 2001—in all of 2001, the IMF disbursed only one payment to Indonesia, amounting to US\$309 million. This was the lowest annual disbursement rate in the entire 1997-2003 period.

In the end, the Bretton Woods institutions grew increasingly frustrated with reform under these conditions of political fragmentation, particularly in the area of governance. The Bank admitted in 2000 that "[p]rogress on governance has been...left largely to a few key reformers who have been moving forward in their respective spheres, garnering whatever support they can muster from senior leaders. These initiatives appear *ad hoc* and a floundering under resistance from well-entrenched vested interests."³⁶

To be sure, the contraction of the policy options available to Indonesian policymakers during this period had more to do with the country's democratic consolidation and with the expansion of the policy arena to new players than with the IMF's behavior. However, as the policymakers' ability to enact reforms declined and as the Fund's trust in government eroded, the IMF turned to more intense micromanagement and coercive guidance, particularly as it had no internal champion in government. In turn, this behavior further constricted Indonesia's policy

space and limited room for any independent initiatives that deviated from what had been agreed with the IMF.

Period 6: Life after the IMF

Indonesian politics was consumed by the legislature's impeachment proceedings against President Wahid in the summer of 2001, when Vice-President Megawati Sukarnoputri took over the presidency. Vulnerable to the same political factionalism that had toppled her predecessor, Megawati focused on her own political survival at first, but was able to remain in office until Indonesia's first direct presidential elections in 2003. Implementation of Fund conditionality crawled forward during her government, and the IMF was willing to accommodate the new president, who was working under considerable political constraints.

As the relationship with the IMF entered its fifth year, voices calling for disengagement grew louder and penetrated the political mainstream. In August 2002, the People's Consultative Assembly (MPR)—the country's highest constitutional authority—passed a degree demanding that the government not renew the IMF program when it expired in December.³⁷ Soon thereafter, the administration decided to let the program expire; relations with the IMF would be reduced to twice-yearly IMF post-program monitoring, decoupled from financing and conditionality, and all remaining debts to the IMF, totaling just over US\$9 billion, would be repaid over seven years.³⁸

Indonesia's post-IMF economic plan, drafted by Megawati's team of technocrats, contained nothing that would have made IMF staffers wince. Its foundations remained low inflation, a balanced budget, and a stable (but floating) exchange rate. Priorities still included tax reform, restructuring the financial sector, and strengthening the judiciary. Similarly, the most influential voices advocating a break with the Fund were not driven by radical policy alternatives, but rather by a general sense that Indonesia should take charge of its own affairs. For example, the Bangkit group, an influential grouping of nationalist economists led by former Finance Minister Rizal Ramli, embraced IMF-style macroeconomic management and had no grand vision of protectionism and industrial policy.

Since the expiration of the IMF program, the range of policy options available to Indonesian policymakers appears to be expanding. Policy space in terms of room for contestation remains very much open, but the new democracy's electoral practices and institutions are beginning to consolidate, and there has been no return to the chaos of the Wahid period. In 2004, Susilo Bambang Yudhoyono became Indonesia's first directly-elected president, giving the Executive much-needed stability of tenure. The new president drastically reduced fuel subsidies in October 2005, a policy his predecessor was unable to implement, even with IMF backing, because of political opposition.

Small but telling changes are also evident in the management of the Consultative Group on Indonesia (CGI), a powerful group bringing together Indonesia's public creditors and usually chaired by the World Bank. In changes that could signal the CGI's shift from a donor-led to an Indonesia-led forum, Indonesia chaired the meeting for the first time in January 2005, and more importantly, the agenda for the meeting was set and prepared by the Indonesian side for the first

time.³⁹ These developments suggest that the government is enjoying growing space to develop and introduce policy initiative initiatives of its own, even in the absence of a Fund program and in a context in which policymaking must be shared with a large number of new actors.

Conclusion

This article has briefly examined Indonesia's engagement with the IMF from the eve of the 1997 financial crisis to the aftermath of the six-year program through the lens of two dimensions of policy space. The object has been to understand how the universe of options policymakers believed were available to them changed over time, and to what degree the contraction or expansion of policy space was caused by interaction with the Fund. The second dimension of policy space—whether new actors can participate in the policymaking process—was also examined as a key condition affecting government-Fund interaction.

Two conclusions about “policy space as menu of options” in the Indonesian case emerge from this exercise. First, engagement with the IMF expanded policy space when the policymakers interacting with the Fund were dominant groups within strong governments, groups that could use the Fund's leverage to secure their political survival and bolster their position against rival interests within and outside government. While technocrats with orthodox ideas typify this role, as exemplified by the period of technocratic dominance (period 2), the Habibie period (period 4) suggests that “nationalist”, non-technocratic groups can also use IMF conditionality to strengthen their own position and open new avenues for policy change. Because the Fund depended on internal champions for influence and access, policymakers in both periods enjoyed some room to take chances and engage in experimentation without Fund opposition.

From the Fund's point of view, these conditions maximized its influence because they guaranteed a modicum of ownership and therefore of government commitment. In addition, the Fund could rely on the government's strong formulation and implementation capabilities. The downside, of course, was that these conditions were fragile. The reform program relied almost exclusively on the political fortunes of the internal champions and on the overall capacity of the state to formulate and implement policy, and in both periods (2) and (4) those conditions proved short-lived.

The second conclusion is that engagement with the Fund closed down policy space in Indonesia when an internal champion failed to materialize, or when the government's willingness or capacity to implement IMF conditions came into question, eroding trust between the authorities and the Fund. In those cases, the Fund turned to its more coercive instruments to prevent deviations from agreed policy. The breakdown of trust was not related to the government's strength of effectiveness—it was evident during the last days of Suharto's strong authoritarian government (period 2) just as it was under Wahid's fragmented democracy (period 5). What really mattered in these cases were the personalities involved and the fact the both Suharto and Wahid's ministers believed that they could feasibly pursue options that significantly deviated from IMF preferences without paying high costs.

In terms of policy space as room for contestation, this exercise suggests that IMF engagement had little impact on the openness or closure of the policy arena. The opening of Indonesia's policy space beginning in 1999 was driven by macro-political forces beyond the control of the IMF or of the government itself. What is clear is that the proliferation of participants in the policy process, and primarily the emergence of the legislature as an assertive player, weakened the government's policymaking capacity and its ability to credibly commit to reform.

These observations suggest a qualification to veto-player approaches that have been used to explain policy reform in East Asia and elsewhere.⁴⁰ From the Indonesian case we cannot generalize that only political systems with an "ideal" number of veto players—a number between the potential arbitrariness of one-man rule and the inflexibility of too many veto players—can deliver reform. The Indonesian case suggests that single veto players can indeed be capricious, and that multiple veto players can produce policy paralysis, but it also demonstrates that when groups in government need the Fund badly enough to ensure their own political survival and to further policy agenda, even structures with very few veto players can deliver reform, if only for a limited time.

Endnotes

¹ Nancy Birdsall, Dani Rodrik, and Arvind Subramanian, “How to Help Poor Countries”, *Foreign Affairs*, 84:4 (July/August 2005), p.145.

² Robert Hunter Wade, “What Strategies Are Viable for Developing Countries Today? The World Trade Organization and the Shrinking of ‘Development Space’”, in Kevin P. Gallagher, *Putting Development First: the Importance of Policy Space in the WTO and International Financial Institutions*, (London: Zed Books, 2005), p.81.

³ South Centre, “Operationalizing the Concept of Policy Space in the UNCTAD XI Mid-Term Review Context”, Geneva, May 2006, p.3. See also UNCTAD *São Paulo Consensus*, TD/410, June 25, 2004.

⁴ See, for example, John Bresnan, *Managing Indonesia: the Modern Political Economy*, (New York: Columbia University Press, 1993); Richard Robison, *Indonesia: The Rise of Capital*, (Sydney: Allen & Unwin, 1986); Adam Schwarz, *Nation in Waiting: Indonesia in the 1990s*, (Boulder: Westview Press, 1994); Andrew J. MacIntyre, “Politics and the Reorientation of Economic Policy in Indonesia”, in Andrew J. MacIntyre and Kanishka Jayasuriya (eds.), *The Dynamics of Economic Policy Reform in South-East Asia and the South-West Pacific*, (Oxford: Oxford University Press, 1992) and Jeffrey Winters, *Power in Motion: Capital Mobility and the Indonesian State*, (Ithaca: Cornell University Press, 1996).

⁵ For a clear exposition of the technocrats’ economic philosophy, see Ali Wardhana, “Structural Adjustment in Indonesia: Export and the “High Cost” Economy”, keynote address at the 24th Conference of Southeast Asian Central Bank Governors, Bangkok, January 25, 1989; reproduced in *The Indonesian Quarterly*, 17:3 (3rd quarter, 1989), pp.207-217. On the role of the technocrats, see Takashi Shiraishi, “Technocracy in Indonesia: A Preliminary Analysis”, RIETI Discussion Paper Series 05-E-008, March 2006.

⁶ The classic case of this dynamic was the fiscally-ruinous management of the state oil company Pertamina in the 1970s by Ibnu Sutowo, one of Suharto’s closest associates. Sutowo’s excesses were reined in only after the technocrats managed to persuade Suharto that Sutowo was jeopardizing the country’s macroeconomic stability.

⁷ Interview with Ali Wardhana, Jakarta, April 11, 2006

⁸ For details, see P.H.M. Jones, “Indonesia: Off Queer Street”, *Far Eastern Economic Review*, 54:13 (December 1966), p.672 and “Finance: Hopes and Fears”, *Far Eastern Economic Review*, 54:13 (December 1966), p.656.

⁹ The CFF is an IMF facility that allows member countries to purchase foreign exchange with their own currencies to compensate for sudden falls in export earnings due to depressed commodity-export prices.

¹⁰ David C. Cole and Betty F. Slade, *Building a modern financial system*, (Cambridge: Cambridge University Press, 1996), p.101.

¹¹ Lloyd R. Kenward, *From the Trenches: The First Year of Indonesia’s Financial Crisis of 1997/98 as Seen from the World Bank’s Office in Jakarta*, (Jakarta: Center for Strategic and International Studies, 2002), p.42.

¹² Interview with Ali Wardhana, Jakarta, April 11, 2006.

¹³ See, for example, Jonathan Pincus and Rizal Ramli, “Indonesia: from showcase to basket case”, *Cambridge Journal of Economics*, 22 (1998), pp.723-734 and Lloyd R. Kenward, “Assessing vulnerability to financial crisis: evidence from Indonesia”, *Bulletin of Indonesian Economic Studies*, 35:3 (December 1999), J. Soedradjad Djiwandono, *Bank Indonesia and the*

Crisis, (Singapore: ISEAS, 2005); and I Putu Gede Ary Suta and Soebowo Musa, *Membedah Krisis Perbankan*, (Jakarta: Yayasan Sad Satria Bhakti, 2003). For an account centered on the IMF's role, see Cyrillus Harinowo, *IMF: Penanganan Krisis dan Indonesia Pasca-IMF*, (Jakarta: PT Gramedia Pustaka Utama, 2004).

¹⁴ Djiwandono, 2005, p.69.

¹⁵ On the controversial injection of central-bank emergency liquidity, see Kevin O'Rourke, *Reformasi: the Struggle for Power in Post-Suharto Indonesia*, (Sydney: Allen & Unwin, 2003), chapter 3 and Charles Enoch, et al., "Indonesia: Anatomy of a Banking Crisis: Two Years of Living Dangerously, 1997-99", IMF Working Paper WP/01/52, May 2001.

¹⁶ The total value of the package is often reported as US\$23 billion, but this includes Bank Indonesia's international reserves. On this point, see Djiwandono, 2005, p.85.

¹⁷ Quoted in Schwarz, 1994, p.77.

¹⁸ Interview with Soedradjad Djiwandono, Jakarta, March 15, 2004.

¹⁹ Regulators who attempted to enforce lending limits and other regulations on banks with politically-connected owners—as did Bank Indonesia Managing Director Binhadi in 1992 and Director General Maritono at the Ministry of Finance in 1996—were removed from their positions.

²⁰ For example, Schwarz writes that Suharto crony Bob Hasan, who was granted millions of hectares in forestry concession areas and controlled all the business associations in the timber-products sector, wielded "considerably more influence over the forestry sector than the Ministry of Forestry". Schwarz, 1994, pp.139-40.

²¹ For an account of the extensive business holdings Suharto's children amassed in the 1990s, see "Children of Fortune", *Time Asia*, May 24, 1999.

²² Interview with Soedradjad Djiwandono, March 15, 2004.

²³ Interview with Saleh Affif, Jakarta, March 18, 2004.

²⁴ World Bank, "Indonesia Country Assistance Note", Report No.19100, Operations Evaluation Department, March 29, 1999, p.9.

²⁵ IMF Independent Evaluation Office (IEO), "The IMF and Recent Capital Account Crises", Evaluation Report, 2003, Annex I, p.76.

²⁶ Coordinating Minister of the Economy Saleh Affif stepped down for health reasons. Director General of Taxation Fuad Bawazier was named Minister of Finance and notorious crony Bob Hasan became minister of trade and industry. Even Suharto's daughter Tutut was on the new cabinet, as minister of social affairs.

²⁷ Colin Johnson, "Survey of Recent Developments", *Bulletin of Indonesian Economic Studies*, 34:2 (August 1998), p.27.

²⁸ On the US government's Indonesia policy during the Asian financial crisis, see John Bresnan, "The United States, the IMF, and the Indonesian Financial Crisis", in Adam Schwarz and Johnathan Paris, *The Politics of Post-Suharto Indonesia* (New York: Council on Foreign Relations), 1999.

²⁹ For informative accounts of this period, see O'Rourke, 2002 and Thoeodore Friend, *Indonesian Destinies*, (London: Belknap Press, 2003).

³⁰ On the politics of this period, see Richard Robison and Vedi R. Hadiz, *Reorganising Power in Indonesia: the Politics of Oligarchy in an Age of Markets*, (London: RoutledgeCurzon, 2005), chapter 7.

³¹ “The Fund-Supported Program in Indonesia: Comparing Its Implementation Under Three Regimes”, remarks by Boediono at the IMF Seminar on Conditionality, Tokyo, July 10, 2001.

³² George Fane, “Survey of Recent Developments”, *Bulletin of Indonesian Economic Studies*, 36:1 (April 2000), p.20.

³³ Boediono, 2001.

³⁴ Marie Pangetsu and Miranda S. Goeltom, “Survey of Recent Developments”, *Bulletin of Indonesian Economic Studies*, 37:2 (August 2001), p.146.

³⁵ In the end, the Fund and the government agreed to leave the amendments to a panel of experts. “Rizal makes little progress in lobbying the IMF”, *The Jakarta Post*, February 23, 2001.

³⁶ World Bank, *Indonesia: Accelerating Recovery in Uncertain Times*, East Asia Poverty Reduction and Economic Management Unit, October 13, 2000, p.43.

³⁷ See MPR Decree VI/2002.

³⁸ In 2006, the government announced that it planned to pay Indonesia’s US\$7.8 billion debt to the Fund on an accelerated schedule, paying half of the debt this year, and the other half in 2007.

³⁹ Hadi Soesastro and Raymond Atje, “Survey of Recent Developments”, *Bulletin of Indonesian Economic Studies*, 41:1 (April 2005), p.12.

⁴⁰ See, for example, Andrew MacIntyre, “Institutions and Investors: the Politics of the Economic Crisis in Southeast Asia”, *International Organization*, 5:1 (Winter 2001), pp.81-122.



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