The IMF and the Indonesian Crisis

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The Indonesian crisis of 1997-8 was unexpected. Indonesia had experienced three decades of consistent 6-7% annual growth, had no serious macro-imbalances and economic policy was in the hands of seasoned experts. Yet it experienced a more severe and longer lasting crisis than its neighbours. This note (and the article on which it is based) does not examine the crisis itself, but looks at the narrow issue of the role of the International Monetary Fund. The point is not to argue that if the Fund had "got it right", then the crisis would not have occurred. The judgments are made on a different and simpler basis: "did the Fund offer the best advice?"

The Fund had identified the 1994-5 Mexican crisis as the "first crisis of the 21st century". The key element of this "new" type of crisis was capital flows (excessive inflows, followed by sharp reversal), a product of the extraordinary globalisation of financial markets during the 1990s. This type of crisis was analogous to a bank run. It is binary ("on/off") in nature – if confidence could be restored, the problem would be solved with minimal disruption.

With this in mind, the policies advocated by the Fund in October 1997 were sensible:

- To try to restore market confidence by demonstrating firm policy resolve.
- To support the exchange rate with a combination of higher interest rates and market intervention.

Restoring confidence, however, is tricky. Demonstrating policy rectitude by closing 16 small banks produced a perverse outcome for confidence. Requiring Indonesia to implement "structural conditionality" raised doubts in financial markets that Indonesia could deliver on all these reforms. Nor is raising interest rates (the second leg of policy) a sure way of supporting the currency. Experience elsewhere (e.g. Sweden in 1992) suggests that the chances of this working would be less (probably far less) than 50:50. Thirdly, while the Fund put together a large support package, the potential outflows were larger still. While it made sense to try these measures, briefly, a more comprehensive "Plan B" was needed.

A month into the program, it was already becoming clear that the rupiah would not be restored and that the banking system as a whole was in serious trouble, because of the very substantial volume of dollar-denominated loans taken out by businesses. Not only was market confidence undermined by the constant drum-beat of disputation between the Fund and the authorities, but the President lost faith in his advisors (domestic and the IMF), with a breakdown of policy dialogue. The binary switch flipped to "crisis" mode. GDP had been expected to continue to grow in 1998, but instead fell by 13 percent. Private capital inflow had been expected to continue to flow in and fund a current account deficit of 4-5 percent of GDP, but instead flooded out, requiring the current account to go into surplus equal to 4 percent of GDP.

What might have been the contents of a "Plan B"? Policy had to directly address the massive capital outflow. The clearest deficiency was the failure to implement the sort of standstill on bank-to-bank debt that was successfully applied in South Korea at the end of 1997. Outflows related to non-bank private debt could have been reduced if the government had vigorously advocated rescheduling – *de facto* default on these private debts. And to the extent that the Government's policy of propping up all banks with liberal last-resort lending served to facilitate capital outflow, this had to be prevented.

The IMF was ill-equipped to offer this kind of flexible response. What was needed was sustained dialogue, with a single Fund team permanently on the ground that had sufficient delegated authority to formulate proposals in response to unfolding events. This "plenipotentiary" team would obviously have needed briefing from Washington, but needed to operate more flexibly. The concentration of negotiations in the hands of the most senior Fund staff (the managing director or his senior deputy) meant that the meetings were always running to a tight timetable and were high profile, with the market on tenterhooks about whether agreement would be reached. Effective policymaking might have been assisted by getting it out of the spotlight. The Fund's own governance system, with its detailed discussions of policy taking place at executive board level, seems particularly ill-suited to this kind of policy making.

Finally, of course, the economic events were being played out in the context of a political crisis, itself catalysed by the economic crisis, under which good economic policy may have been simply infeasible.

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