



# PRIVATE CAPITAL FLOWS AND THEIR EFFECT ON DEVELOPING COUNTRIES

SOME LESSONS FROM THE INDONESIAN EXPERIENCE

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## Introduction

This paper is about the lessons of the Indonesian economic crisis for the future of development assistance and government policy for recovery. It highlights how even the most successful of developing countries can find themselves at the vortex of a financial whirlpool which can undermine over three decades of growth and development. Indeed, the Indonesian case is a good illustration of how a country with a track record of high growth, combined with a sustained reduction in absolute poverty and relatively equitable distribution of income, can in a short span of one year find most of its industry reduced to bankruptcy, its public institutions in disrepute and its government scrambling for external aid.

The Indonesian case provides support for many of the propositions mentioned in the background paper to this conference: a fiscal squeeze as the tasks facing the government outpace its revenue, the importance of governance and institutional reform as a sustainable way out of the crisis, and the need for an equitable sharing of the costs of overcoming the crisis. It also provides ample evidence, if this were still needed in the third year of the crisis in East Asia, of the dangers of financial liberalisation and open capital accounts without having first built up appropriate regulatory institutions.

There are other issues on which this paper presents a slightly different perspective. It argues that contrary to a priori expectation volatility in private capital flows was not the root cause of the economic crisis in Indonesia. True, private capital flight was a trigger for a currency collapse. Yet, both foreign direct investment and short-term portfolio capital expanded steadily for a number of years before the crisis. If volatility is measured as an oscillation around a trend line, Indonesia did not suffer from volatile capital flows. Instead, it is a good example of a virtuous cycles of investment and growth in which external capital played an important contributory part. This simply illustrates the fact that despite capital account convertibility, private capital flows have benefitted only a select group of developing countries.

Another pivotal message of this paper is that without a significant change in the global financial architecture, developing countries are unable to effectively sterilize the impact of large private capital flows. So the capital volatility problem cannot be easily solved at the source. The more realistic policy option is therefore to find ways of becoming more resilient to the adverse impacts of future such crises. It is here that the structure of a country's institutions can make the greatest difference. The paper agrees with the approach taken by Sen (1999) and Rodrik(1999) that it is countries which are able to best manage the latent distributional conflicts generated by severe crises that are able to maintain sustainable development paths. It argues that recovery involves a public consensus about sharing the costs of the crisis among different stakeholders.

Since participation as a process is part of a strategy for recovery, governance and institutional reform is a bad candidate for foreign aid conditionality. In any event, there are no unique, universal models of ideal governance. In the field of governance, dialogue and mutual learning are more efficient than pressure and loss of policy independence by the recipient government. The call to solve some of the economic governance in Indonesia by the creation of “autonomous institutions” is a especially inappropriate policy choice. What is needed first is the establishment of democratic oversight mechanisms before institutional autonomy can make policy sense.

As far as development finance is concerned, Indonesia has seen a dramatic reversal in the structure of its external finance. Public flows (mostly foreign aid) have replaced private flows as the principle means of closing its budget deficit, itself a new phenomenon in the wake of the crisis. It is very likely that Indonesia will continue to depend on foreign aid for a number of important policy areas including social safety nets, bank recapitalisation and reform of its political institutions. It might also need foreign aid to build key physical infrastructure in resource rich regions that are unable to reach their full potential in terms of export volumes. In this context, it is time to find new ways of complementing future private investment flows with foreign aid commitments. The democratic transition underway in Indonesia provides an excellent opportunity for exploring how this can be achieved on the ground.

### **Global capital flows and the question of volatility**

One of the fortunate benefits of crises is that it concentrates the mind of policy makers on essentials. The recent currency collapses, spiralling foreign debt, and falling domestic demand in several large developing and middle income countries such as those in East Asia, Russia, and Brazil have therefore brought the issue of the impact and the containment of volatility in private capital flows back into focus.

The question of volatile capital flows is hardly new in development thought. Back in the 1960s and early 1970s, before the break down of the Bretton Woods fixed exchange rate system, a favourite question in development economics examinations concerned the destabilising effects of speculative capital flows. The favoured answer was that volatility of short-term capital flows was more of an information problem than anything else. In a competitive and open capital market, different speculators would have different perceptions of risk. With enough actors in the market, bulls would match the bears. There was little reason to expect systemic collapse.

Open and competitive capital markets would also improve the efficiency of allocation of global savings and investment. An integrated global economy with free movement of trade and investment had other advantages. One of the most promising was the opportunity for even low-income developing countries to

supplement their meagre domestic savings with foreign savings. This was important for raising investment levels and the rate of economic growth. In many cases foreign savings not merely added to the stock of domestic savings but were actually complementary to it. Two-gap development models drove home the point that foreign savings would ease both a domestic saving as well as an import or foreign exchange constraint.

Until the mid-1990s, many influential texts on global capital markets had a standard refrain. Participation in the world capital markets generated both risks and opportunities. The risk came from two directions. First, unsound macroeconomic policies, usually unsustainable budget and current account deficits, might trigger sudden outflows of capital. The result would be downward pressure on the exchange rate and a threat of high inflation. Second, large, unsterilized capital inflows would create the opposite problem. The nominal exchange rate would strengthen, undermining export competitiveness and subsequently when foreign exchange is sold for local currency might even fuel inflation.

However, on balance, it was argued, the benefits greatly outweighed the risks. These consisted not only of higher levels of investment, but also the transfer of new technology and access to international markets. There was yet another advantage to open capital markets. This came in the form of market-imposed macroeconomic discipline on otherwise spendthrift governments. To maintain the confidence of outside investors, individual governments had to contain budget and current account deficits, maintain low inflation rates and exchange rate stability. The result would be a diminution of state intervention in the economy and promote a more efficient allocation of resources as loss-making state enterprises were privatised and state monopolies dismantled. As Krugman points out, the gospel of market openness was refined and fine-tuned in numerous meetings of finance ministers and economic opinion makers around the world and in the corridors of international financial institutions. Soon, by the beginning of the 1990s the theology of competitive markets and sound money was enshrined in what became known as the Washington Consensus.<sup>1</sup>

Hardly had the ink dried on the Washington Consensus when the Mexico crisis broke. It cost international tax-payers more than \$40 billion, and much arm twisting of private creditors by the United States to resolve. The Mexican crisis forced a reassessment of both the risks and the benefits of participation in global capital markets. The key realisation was not just that the risks of sudden reversals in private capital flows could trigger a currency collapse and sharp price increases

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<sup>1</sup> As Krugman (1996) writes:

“ At the same time as this self-reinforcing process was underway in the financial markets, a different kind of self-reinforcing process, sociological rather than economic, was taking place in the world of affairs--- in the endless round of meetings, speeches and exchanges of communiqués that occupy much of the time of economic opinion leaders. Such interlocking social groupings tend at any given time to converge on a conventional wisdom, about economics among many other things. People believe certain stories because everyone important tells them, and people tell them because everyone important believes them”

but also that the gains from the standard Washington Consensus prescriptions were themselves questionable.<sup>2</sup>

The East Asia crisis was another landmark in the history of capital-volatility induced crises in the global economy. This time the bill to the tax-payer was over three times that of the Latin American crisis. The economic slump in East Asia also highlighted several new characteristics of such crises. Currency crises generated an almost random pattern of contagion, affecting countries only marginally linked by trade flows. Often the contagion affected entire regions rather than individual countries. It was often linked only weakly to the strength of macroeconomic fundamentals, to the composition of capital flows and even to exposure to international debt. Another feature of the economic depression in several Asian economies was the speed and the depth of the transmission from foreign exchange markets to the real economy. Collapse of the real economy undermined even long-standing social structures and political institutions. The inevitable result was a loss of confidence not only on the part of international investors but, more importantly, by the general public in the entire institutional framework of the country in question.

It would appear that the enquiry into the causes, impact and management of volatile private capital flows has meandered across an unusually varied analytical terrain. What began as a small part of an argument on fixed versus floating exchange rates, rapidly moved on to an examination of the contribution of capital flows to global welfare. In an era of aid fatigue in the late 1980s and 1990s, private capital flows, despite their volatility were seen as an indispensable catalyst of sustained economic growth, underpinned by the ethos of the Washington consensus. With the advent of one of the most dramatic reversals of economic fortune in East Asia in recent economic history, the pendulum has swung again: towards seeing private capital flows in an open global capital market as being the source of contagion, economic collapse and social discord.

The literature on private capital flows in recent years is vast. It is growing by the day. Yet the central policy concerns are relatively clear. If the private capital market does not by itself dampen speculative fluctuations, is there a case for partial closure of capital accounts or for more careful and sequenced liberalisation of capital markets? If we accept the need to maintain open capital accounts and have to withstand future currency (financial market) driven economic crises, what can we learn from the current crisis in East Asia? The two are not unrelated questions, but the focus of the underlying discussion is different. This paper takes as its starting point the latter question as it applies to the Indonesian experience.

The Indonesian case is relevant to our understanding of both the transmission mechanisms by which financial market volatility can quickly spill

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<sup>2</sup> Mexican data indicate that despite massive capital inflows of around \$30 billion between 1990-94, output growth in Mexico averaged only 2.5% per annum, less than the population growth.

over into the real economy and into the lives of ordinary citizens. It also illustrates an important aspect of crisis containment and subsequent recovery. This is the asymmetry between the advent of a financial crisis and the means for emerging out of it. The Indonesian example shows rather forcefully that the road to recovery involves more than simply reforming banks and corporations. The suddenness and the severity of the economic crisis in Asia, unleashed by loss of investor confidence, carries with it not only the explosive impact of frustrated expectations,<sup>3</sup> but also raises the central ethical question: how are the costs<sup>4</sup> of fixing the crisis to be shared<sup>5</sup> and what is the opportunity cost of different arrangements for meeting these costs? These latent distribution conflicts cover not only the most obvious ones between foreign creditors and domestic debtors, but also conflicts between regions, between small and large enterprises, between employers and employees and between the poor and the rest of society.

## **II. The advent of the economic crisis in Indonesia: a perspective**

The contours of the Indonesian economic crisis are by now well known and need not be surveyed here again. A number of observations are however, relevant to our discussion here.

First, if normally astute observers were unable to predict the scale and severity of the economic crisis in East Asia they were able to do it even less in Indonesia. The background paper for the 1998 July Consultative Group Meeting recalls the situation just one year earlier as follows:

“Just a year ago, Indonesia was enjoying its 30<sup>th</sup> year of virtually uninterrupted rapid growth. Investors were beating a path to its door demanding to participate, and contribute, to its growing prosperity. Inflation was low, foreign exchange reserves plentiful, the government budget in surplus. The comforting proximity of other booming East Asian economies generated synergies for Indonesia through trade and capital flows. These mixed with high levels of domestic savings and investment, promised little interruption to continued rapid development and poverty reduction.”<sup>6</sup>

A year later, the Indonesian economy lay in ruins. The rupiah collapsed to less than a fifth of its value to the dollar. External credit froze. A country with a record of balance budgets and single digit inflation stood at the verge of

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<sup>3</sup> A.K. Sen (1999) quotes Wolfensohn's speech at a meeting of the Board of Governors as follows:

‘ But today I have other memories. Dark, searing images of desperation, hopelessness and decline. Of people who once had hope, but have it no more. The mother in Mindanao, pulling her child out of school, haunted by the fear that he will never return. The family in Korea with a mid-sized scrap metal business, made destitute through lack of credit. The father in Jakarta, paying a money lender three times in interest what he can make that day, falling deeper and deeper into debt. Not knowing how he will ever work himself free.’

<sup>4</sup> See Appendix table 1, reproduced from Frydl (1999). Although the measurement of the cost of banking crises is not easy they can be substantial as several of the Latin American cases show. The extreme is Argentina where these costs amounted to over 55% of GDP.

<sup>5</sup> For an excellent account of the importance of conflict resolution mechanisms in a country's ability to undertake successful macroeconomic adjustment, see Rodrik (1999)

<sup>6</sup> World Bank (1998), p. 1.

hyperinflation. The sharp decline in the exchange rate led to a massive explosion of the cost of external debt service in local currency. Given that between 1992 and 1997 close to 85% of the increase in Indonesia's external borrowing was due to private sector borrowing abroad, the currency crash made most corporations and banks unviable. A contributing factor was the short maturity of private sector debts combined with a large debt stock. Under a system of *de facto* fixed exchange rates and general investor confidence in Indonesian macroeconomic management, the large debt stock was not a matter of concern. When the crisis struck, Indonesia's debt structure brought down the entire edifice of industrial growth built on a close partnership between banks and business conglomerates built on the ease and low cost of offshore borrowing.

Second, the speed of the financial market generated shock to the real economy was faster than anticipated. In the early months of the crisis, the government, with IMF advice, was more concerned with the need to stem capital flight and control the threat of hyperinflation than with a collapse in domestic demand and a contraction in the real economy. A standard recipe of high interest rates and a budget surplus was therefore tried. The result in retrospect was to make the output fall much worse than it might have been otherwise. The result was to convert a currency crash into a full-scale economic depression. As IMF (1999) admits, projections of post-crisis fall in output were continually revised downwards. In characteristic terse prose it reports:

“ The depth of the slowdown was not foreseen in the initial program projections, and growth projections in particular were revised sharply and successively downward during the course of the programs.”<sup>7</sup>

In the end, what began as a 4% predicted fall in GDP for 1998, was successively raised to a contraction of around 14% in real output. Given that the pre-crisis GDP averaged at around 7%, a 14% fall in the course of a single year meant a more than 21% output fall. This is easily comparable to output falls in Eastern European socialist economies in the early years of their economic transition following the collapse of the Berlin Wall. The difference was that this was in Indonesia, a market economy, with a proven record of macroeconomic stability, numerous waves of earlier deregulation and market oriented economic reform, a high record of domestic savings and a record improvement in its labour skill base.

Third, the social costs of such a sudden output collapse were high enough to bring down a system of government which had lasted almost thirty years. These costs consisted of rising levels of unemployment, (which in any event remain hidden rather than open), massive inflation shocks<sup>8</sup> on the average household due

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<sup>7</sup> IMF (1999), p. 49.

<sup>8</sup> The inflation shock caused an explosion of poverty, captured in the phrase the 'new poor'. The term refers to households who were above the poverty line before the crisis, but fell below it as a consequence of a combination of the inflation shock and the unemployment and real wage declines associated with the collapse of domestic demand (the recession shock). As the rate of inflation falls, the incidence of poverty is expected to fall. The recession induced poverty will take

to an escalation in food prices, and a deterioration in the provision of public services. The precise strength of the magnitude and the location of each of these factors has been a matter of some debate, perhaps normal in a period of great uncertainty and rapidly adjusting relative prices. Nevertheless, there is by now general agreement that the social costs of the crisis, measured in terms of the proportion of the Indonesian population below the poverty line, have been nothing short of dramatic. This proportion now stands at 24% relative to 11% in 1996. This doubling of poverty levels at a time of slower anticipated growth rates in the medium term means a decade long reversal in the gains on poverty eradication.

The political fall out of the crisis has however less to do with immediate impoverishment of the Indonesian population than from the psychological shock of the crisis on the average Indonesian citizen. The immediate impact of the crisis on unemployment and poverty was less severe than might have been anticipated due to various coping mechanisms used both by individual firms and communities. Many firms held on to the labour force through a reduction of working hours and suspension of bonuses. Communities responded by raising household dependency ratios and by migrating back to the rural areas. Many sold of assets and kept their children in school. Indeed some of the household surveys conducted at the time detected relatively little social distress measured in terms of consumption falls or school drop out rates.

The psychological shock of the crisis was however very severe. It was partly due to the fact that the pattern of earlier growth had actually managed to give something to everyone (economic disparities in Indonesia bore little comparison to the situation in most Latin American countries), and partly because of widespread belief that the crisis was due to endemic corruption at the highest levels of society which had sacrificed the interests of the country through an unholy union of large domestic conglomerates and unscrupulous foreign creditors. This perception was further encouraged when the precise magnitude of private debt, around \$80 billion, was known. A much ridiculed picture of Mr. Camdessus standing with folded arms over a supplicant President Suharto signing on the dotted line of an agreement with the IMF did not help to rebuild public confidence.

Riots broke out. The government fell. The new government reiterated its commitment to economic reform as outlined in the Letter of Intent to the IMF. With the completion of parliamentary elections in June 1999, a new President is expected to take charge in the latter part of the year.

So much for perspective. The question that arises is the extent to which private capital flows are to blame for the crisis, and whether the root causes and

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longer to eliminate. Hence the view that the crisis might have raised the "stock" of poverty in Indonesia. The total stock of poverty will then include the old poor who were already below the poverty line before the crisis plus those households who remain below it due to a combination of the inflation and recession shocks.

the cures for the crisis have been correctly identified in the current reform agenda. Let us take each of these issues in turn.

### **III. Was the volatility of private capital flows to blame for the Indonesian crisis?**

Are volatile capital flows responsible for the Indonesian economic crisis? This is a simple question that can be answered at two levels. In terms of arithmetic, the answer is affirmative; sudden and large capital flight was the immediate trigger for the crash of the rupiah. But there is a subsequent and deeper question. What drove capital flight: Was it bad government policy or external factors over which Indonesia had no control? The answer to the latter question determines to a great extent the choice of crisis management and recovery strategy. This is a very complicated issue and needs some attention.

First, let us examine the arithmetic. In Fiscal Year (FY) 1996/97, total net private capital inflow stood at \$13.5 billion. This was almost equally divided between direct investment and other flows consisting of portfolio capital and loans. The former amounted to around \$6.5 bn, and the latter some \$6.9. In the following year, the picture changed dramatically. Total private capital flows registered a negative \$11.8 bn. Both direct and other forms of private flows registered a massive decline. The former fell to \$1.8 bn while the short-term flows recorded a negative net flow of \$13.7 bn. 1998/99 estimates indicated a continuing fall with FDI reduced to a trickle of \$0.1 bn and short-term capital continuing to decline by a further \$10.3 bn. Overall, the period between FY 1996/97 and 1998/99 saw a decline in net private capital flows of around \$34 bn. The magnitude of this outflow was comparable to more than *six* years of all official capital disbursement prior to the crisis ( at just over \$5.0 bn per year from 1990-1996).

In terms of volatility, it is obvious that short-term capital (portfolio and others) showed the most noticeable variation. Yet the picture is not quite so simple. Table 1 presents a longer series of a segment of the Indonesian capital account. Two features should be noted. First, prior to the onset of the present crisis, neither FDI nor short-term capital flows showed much downward variation. Sudden upward shifts in both components of private capital flows followed periods of earlier economic reform and deregulation. Second, when the present crisis struck, both FDI and other capital declined sharply, but the fall in the former was less than the latter. *Before the crisis therefore, movements of FDI and short-term capital were rather similar; during the crisis the direction has been the same even if magnitudes vary.* The common generalisation that volatility of private capital flows to developing countries depends on the composition of such capital between FDI and short-term flows is, therefore, only very partially applicable to the Indonesian experience.

Indonesia does not therefore exhibit a case of long-term instability of private capital flows before the present crisis. It is in effect an example of a virtuous cycle of fast growth and macroeconomic stability generating high inflows of capital which in turn continued to finance the gap between domestic savings and investment. Moreover, under a regime of de facto fixed exchange rates, short-term loans from external creditors to Indonesian banks and corporations were also used to finance long-term investment. Thus the common distinction between FDI which is classified as long-term capital flow and private short-term credit continually rolled over to finance domestic investment in ventures with long maturities is also too superficial in the Indonesian context.

The answer to the initial question of whether the volatility of private capital flows brought about the current crisis in Indonesia therefore can be answered as follows. Yes, private capital flight was the immediate trigger for the currency collapse and the ensuing crisis. It was not however the result of endemic volatility in short-term capital flows. In fact over a fifteen year period data show a close correlation between movements in FDI and other types of private capital flows. This was because the maintenance of fixed exchange rates in a context of macroeconomic stability encouraged the use of short-term private capital flows to finance domestic investment and economic growth. In fact, in retrospect, until the crisis Indonesia was doing everything according to the Washington Consensus textbook. This text although not openly advocating fixed exchange rates did approve of their use in a multitude of transition economies in Europe. The key determining factor here was the sensitivity of the Washington Consensus recipe towards the possibility of rising inflation. The fact that this was not a problem in Indonesia prior to the crisis was never a serious consideration of policy.

The Indonesian experience is a good illustration of the dilemma facing even a successful developing country trying to navigate the treacherous waters of present day global capital markets. According to the risk and opportunities story, the risks can be managed through effective sterilisation of such flows. The problem is that no one really knows how to do this and still enjoy the benefits in the form of access to external capital markets as a source of development finance. Sterilisation of capital inflows often involves promoting capital outflow, which undermines the use of such flows for development purposes. In addition, many of the instruments for managing large flows do not exist in developing countries, being themselves the result of a minimum market volume of operations and hence market liquidity.<sup>9</sup>

Another important factor is the size as distinct from the variation in capital movements. As late as the mid-1990s, a country's net foreign exchange reserves measured in terms of months of import covered were considered to operate as a cushion against sudden reversals of investor confidence. This is now old history.

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<sup>9</sup> There is much literature on the science and art of managing short-term capital flows. Most of it is inconclusive. The authoritative version presented in IMF (1998) presents a large menu of different central bank options, not of them with significant disadvantages as well as possibilities.

The spectacular speed of the growth of the global capital market<sup>10</sup> as well as its sheer size ( presently estimated to transact some \$1.5 trillion per day) has changed views about what individual countries can do to manage sudden adverse swings in private capital flows.<sup>11</sup> The task of managing private capital flows is made even more difficult by structural shifts taking place in the global capital markets, such as the use of customised derivatives, the power of institutional investors and the desegmentation between financial and non-financial instruments.

What can we say therefore about private capital volatility in the context of the Indonesian crisis? First, it appears that neither FDI nor short capital showed much volatility until the crisis struck. In fact they exhibited fairly long periods of stability and growth. Second, the absolute size as well as the percentage swing matters in terms of determining the impact on market expectations and confidence. Indonesia's large foreign exchange reserves were dwarfed by the anticipated capital outflow. Third, even if the crisis had not occurred when it actually did the task of managing such large short-term capital flows might have eventually reduced their utility as instruments of development finance. Thus even if the government had been able to manage the macroeconomic impact of these flows better it would not have been able to defer a crisis indefinitely.

It is the complexity of the global capital market as well as the wide range of factors governing investor behaviour and choice that have prompted the view that private capital flows are increasingly governed by herd behaviour and self-fulfilling prophecies. The explanation for sudden outflow of capital from Indonesia is therefore related to *loss of investor confidence* first due to contagion from other countries in the region and later to the discovery that short-term private debt was much greater than had been initially expected. Whether the external causes, such as contagion, slowing of export growth and so on, outweighed the internal contributors to the crisis: lack of transparency, close link between government and private banks etc., is still a subject of debate. In terms of policy-making however, program conditionality and design has stressed the latter.

If the strength and influence of the global capital market is taken as a given, and if closure or partial closure of the capital account is not a realistic long-term policy option,<sup>12</sup> the alternative approach to withstanding the adverse impact of capital flight is to shorten the period between crisis and recovery. This brings us back to the risks and opportunities paradigm. The question then reduces to the mechanisms available for mitigating the financial and the human costs of such

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<sup>10</sup> The market for foreign exchange is the fastest growing component of the international capital market. The daily turnover in this market was estimated at around \$10-20 bn in 1973. By 1992, the Bank of International Settlements calculated this amount to be close to \$900 bn. Today the figure is around \$1.5 trillion. Movements of individual components in the global capital market can be seen by McKinsey's estimates of the total stock of financial instruments traded in the world market in 1992 at around \$35 trillion. This is expected to increase to \$83 trillion by the year 2000, or twice the combined GDP of all the OECD countries (see Mishra, 1998).

<sup>11</sup> Britain's sizeable foreign exchange reserves did not save it from having to exit the ERM, neither did Indonesia's \$20 bn reserve save it from a currency collapse.

<sup>12</sup> With the *de facto* substitution of foreign aid for private development finance, subject to a number of programme conditionalities, closure of the capital account in Indonesia is unlikely to be a short-term policy option too.

crises in the future given that such crises will remain, in the absence of a major change in the global financial architecture, a fact of life.

Indonesia, under support from its multilateral donors tried just such an approach. A number of lessons are beginning to emerge. They are not the lessons which were initially expected. That is what makes the Indonesian crisis especially significant as a learning mechanism for a range of other developing countries.

#### **IV. Curing the patient; prescription and results**

The present economic crisis in Indonesia, and the concomitant efforts at system-wide reform, is the fourth such episode in the post-independence period. The others such as the stabilization of the economy at the start of the New Order government (1966-70), the years following the collapse of international oil prices (1982-86), the acceleration of deregulation and economic liberalization (1987-93) all succeeded in shifting the economy to a higher growth trajectory while maintaining macroeconomic stability. However, the current crisis is arguably the most severe as well as the one that throws up the hardest policy challenges. There are several reasons for this.

The approach to a resolution of the Indonesian slump is crystallized in a series of Letters of Intent submitted to the IMF/World Bank in Washington. Simply put, it locates the principal cause of the crisis as a failure of key regulatory institutions in the banking and corporate sector. Indonesia's strong performance, measured in traditional macroeconomic indicators such as the current account and budget deficits, the rate of inflation and the growth of GDP, precludes placing the blame on economic "fundamentals". Consequently, as a recent review of the region by the IMF argues, the fact that the crisis resulted from a failure of institutions, implies that the key to recovery must also lie in *structural reform*.

Given the size of private foreign debt in Indonesia, often estimated at around \$80 bn, much of which under *de facto* moratorium, the two sides of the Indonesian economic problem are reduced to being the relationship of lenders and creditors. The former involves making banks profit-worthy and cleaning up bad debt. The latter is dealt with either through mutual renegotiations of past obligations or through newly enacted laws on bankruptcy. Finally, ensuring that such crises do not repeat themselves requires a more arms length approach by government to banks and corporations. Improvement in economic governance, often a polite way of referring to corruption, provides the other element of the reform drive. It is claimed that a determined attempt to carry through structural reforms while keeping monetary policy tight will regenerate badly bruised investor confidence and sow the seeds of a virtuous cycle. Foreign capital will return. Easier finance for working capital will begin to raise domestic production and export levels. Real wages and employment will once again approach pre-crisis levels.

According to the above policy prescription therefore the root causes of the crisis are internal. They are located more specifically in the governance of banks and private debt/equity compositions. It is not surprising therefore that the bulk of the policy attention, and much of programme resources are devoted to bank recapitalisation and orderly corporate debt resolution. Social safety nets and political governance have appeared relatively late on the development agenda. The former was due to a better appreciation of the impact of the crisis on poverty and on regional disparities in income distribution. The latter is directly related to political uncertainties linked to the changes in government and the evolution of a more democratic and decentralised system of government in Indonesia.

With such a clear emphasis on winning the confidence of foreign investors it is perhaps to be expected that many external observers have adopted a rather optimistic interpretation of the current economic situation. Yet most of the good news comes from the macroeconomy that was not identified as being a major problem prior to the crisis.

The rupiah has stabilized, despite political uncertainty and sporadic outbreaks of ethnic violence, at around 7500 to the US dollar. The rate of inflation is estimated (by the World Bank, March 99) to have fallen to around 33% in FY 98/99 compared to 70% in FY 97/98.<sup>13</sup> The government targets continued falls in CPI to around 15-20% in FY 99/00.<sup>14</sup> As a result nominal interest rates are also beginning to decline: from a peak of 70% in August 1998, for one month SBI (Bank of Indonesia certificates), to around 13% at present. In parallel the Jakarta Stock Market index strengthened from a low of around 273 in mid-1998 to just over 560 at present.

The twin deficits also show movement. The current account has moved into surplus largely due to import compression. The forecast for FY 99/00 is a current account surplus of around 1.1% of GDP compared to a deficit of 1.4% in FY 98/99.<sup>15</sup> This is expected to be the result of a 11% contraction in imports in all categories combined with 0.7% export growth. In the government sector, the realized budget deficit, assumed at around 8% of GDP in July 1998, is now calculated at 4.4% due to problems of public expenditure disbursement and absorption capacity of external aid flows.

The real question is how to interpret these macroeconomic indicators as signals of an impending economic recovery. If the macroeconomic fundamentals were not underlying causes of the crisis to what extent can they be used as indicators of recovery. Some, such as the current account deficit can be signs of economic slowdown rather than growth. Others such as the rate of inflation while key to stabilizing the exchange rate, were the result of capital flight and a plunging exchange rate to begin with. With the substitution of foreign aid for

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<sup>13</sup> World Bank (1999), Indonesia: Country Assistance Strategy – Progress Report, Feb. 16.

<sup>14</sup> Government of Indonesia(1999), Memorandum of Economic and Financial Policies, paragraph 5.

<sup>15</sup> Asian Development Bank( 1999), Country Economic Review, March, p.15.

private capital flows, the collapse of the domestic market, the slowing down in the *rate* of capital outflows, and the end of the drought it is not surprising that inflation continues to fall. How convincingly can the improvement in inflation rates be linked to an effective design of the economic reform program rather than as an offshoot of demand contraction is still an open question.

Progress on the two major areas of structural reform highlighted in the IMF supported reform program remains lackluster. The Jakarta Initiative for private debt restructuring, which led to the creation of the INDRA (the Indonesian Debt Restructuring Agency) has still to attract any serious takers, while IBRA, the bank restructuring agency is mired in internal political differences on the issue of bank closures. Bankruptcy laws have been drafted but implementation is impeded by the shortage of qualified judges and a credible judicial system.

The usual structural indicators arising from the banking and the corporate sector reform do not therefore give much ground for optimism regarding an early economic recovery. In addition, the structural reform agenda bears all the hall marks of ad-hoc learning-by-doing. The economic governance component is a wish list of all possible institutional improvements. These range from cancellation of flawed government contracts and improving procurement regulations to regional decentralization and promotion of community organizations to disburse social safety net funds.

## **V. Widening the structural reform agenda: governance and institutional reform**

What is striking about the management of the Indonesian economic crisis is the continuous evolution of the policy design as the crisis proceeded. The early calls for the budget surplus were turned into a need for budget stimulus. Increasing economic distress and its political fallout led to an emphasis on a more effective implementation and targeting of social safety net resources.

The political transition has created demands for attention to political governance including anti-corruption measures, the creation of a judicial system rooted in the rule of law, the reform of the civil service, the decentralisation of administrative authority to lower levels of government and the empowerment of civil society as an indispensable instrument of social equality. The original reform agenda has therefore undergone both evolution as well as marked expansion. This raises key issues of both programme balance as well as the trade-off between implementing different policy measures given the existing budget constraints generated by reduced government revenue and limited donor resources. These raise thorny questions not only of the economic opportunity costs of different sequencing alternatives between individual reform measures in the future but also normative issues of justice and the benefits of a democratic political system. The latter by their very nature require public debate and consensus. However binding a fiscal constraint may be, questions relating to the limits of alternative fiscal

allocation to such diverse activities such as bank recapitalisation, social safety nets and political institution building are in essence matters of value judgement and cannot be resolved within the economic domain alone. A brief review of some of the most critical elements of governance linked reform in Indonesia provides some idea of the difficult terrain over which both policy makers and the donor community will have to tread in the future.

### Components of governance related structural reform in Indonesia

#### *Curbing corruption*

This is arguably the most visible item of governance reform in the Indonesian reform agenda. The current Bank Bali scandal simply reinforces this concern. It is also clear that any program for combating corruption in Indonesia can only be successfully implemented through a strong partnership between government, business and civil society.

For all the sophistication of the current design of the anti-corruption strategy, from legal reform, revision of civil service salary scales, to community corruption watch, progress on this front will take a very long time. The central merit of the anti-corruption strategy is to instil confidence that Indonesia means business in tackling this problem not in being able to link improvements in some corruption index to the speed of economic recovery in the near future.

The corruption issue illustrates some of the difficult problems of delineating the economic from the sociological and ethical dimensions of a governance system. Since corruption is often regarded as driven by greed rather than need, no feasible scale of salary revision in the civil service will be enough to solve the problem. Community watch will work only in some of the gains from lower corruption, such as the greater availability of public funds for repair of community services, actually filter down to the community. Establishment of independent investigative bodies is open to abuse, and might actually fuel corruption unless adequate mechanisms of political control are implemented. Co-ordination of these different initiatives will continue to largely remain in the hands of the state.

The output of all the anti-corruption reform measures is not easy to measure. The famous Transparency International country rankings on a corruption scale suffer from reflecting a business enterprise view of the problems encountered in undertaking business operations. But dealing with corruption is also important from the perspective of public as opposed to business confidence. In the inter-linked economic and political reform underway in Indonesia today the former is arguably even more critical than the latter. This implies a balance between catching the “big fish” who might be responsible for large revenue losses and the small bureaucrats who lower confidence in the country’s overall system of governance just because they are numerous and affect every strata of society.

### *The optimal size of the state and public management reform*

The role of the state as a facilitator and promoter of governance reform opens up a key lacuna in Indonesian economic reform. This is the question of the optimal size of the state and whether the range of economic and political reforms on the table corresponds to the capacity of the state in effectively performing its role as an agency of reform.

Given the range of reforms envisaged, it is important to revisit the issue of the desired size of the state in Indonesia. The scale of the reform effort in Indonesia bears close comparison with that outlined in an influential paper by Fischer and Gelb (1993) discussing the reform of transition economies in Eastern Europe. Yet the state in Indonesia is a small state accounting for less than 20% of GDP. This is considerably smaller than the OECD countries' current average of 47.7%; countries whose governance systems it might be trying to emulate.

The smallness of the state and the magnitude of the reform task may well lead to a case of reform overload. This might actually increase rather than decrease some forms of corruption as some programs are implemented slower than others.

Abimanyu (1999) makes the important point that insufficient attention to the optimal size of the state has simply resulted in the proliferation of off-budget accounts which were used not so much to finance personal consumption but to expand the state structure itself. Under a very strict interpretation of the rules, this might be identified as corruption. He therefore rightly argues that the "fundamental issue is therefore the size and role of the state, not the balance of funding between official and unofficial sources" (Ibid, p.9).

The lesson is that the size of the reform program must be commensurate with the size and capacity of the state. An anti-statist stance at a very time to maximal reform pressure is self-defeating. This is nowhere more evident than in the area of governance reform which requires not just new legislation but the mobilisation of entire communities to engage in an intensive search for a locally optimal structure of governance.

Insufficient attention to the size of the state also carries the risk that some of the co-ordination and regulatory responsibility of the state are devolved almost by default to entities outside the state. Initiatives such as public-private partnerships, regional decentralisation and the establishment of independent institutions outside the purview of government, are important innovations in finding new governance solutions to the economic and political transition. However, without adequate safeguards and scrutiny they might just as easily become a fiscally convenient ways of dumping some of the responsibilities of the state on those least able to perform them.

### Community contributions to good governance

Both the historical tradition of community-based support systems and the political reform underway implies a much stronger role in creating the enabling conditions for good governance. Yet, while the role and the deficiencies of the state have received much attention, relatively little has been done on the strengths and weaknesses of the community in fostering good governance. Here, it is not at all obvious whether civil society left to itself would *ipso facto* promote the cause of market-friendly governance.

In fact Kolodko's (1998) analysis of institutional reform in the former socialist countries of Eastern Europe makes the interesting observation that a power vacuum left by a weak state in an intensive period of reform may well give rise to local elites who openly engage in corrupt practices. They may also erect informal trade barriers as a means of generating local revenue.

Yet, the picture is not all black or white. Communities evolve and change. At times they can be agents for change, at others they appear to be bastions of conservatism and a patron-client relationship. For an effective reform of the governance system, the community as well as the state needs to be placed under the analytical microscope.

### Regional Decentralisation and Conflict Resolution Systems

Without doubt, regional decentralisation is the most ambitious single item of institutional reform being attempted in Indonesia. The underlying rationale is both economic (an improved allocation of resources), and political (safeguarding national unity).

The regional decentralisation question again illustrates the need to tread carefully in the field of institutional reform. The experiences of several other developing countries: China, India, Brazil, not to mention Russia, provide a rich menu of all that can go wrong with economic decentralisation. There is also heavy path dependence.

In Indonesia, two questions remain unanswered. The first is the how to provide a lasting mechanism for stalling latent conflict not between centre and the region but between rich and poor regions. The resolution to this problem will lie not only in institutional arrangements such as equalisation funds but in building a national consensus on minimum welfare norms to which all Indonesians qua citizens might be entitled. The second is to put incentive systems in place which prevent regions from erecting trade barrier to internal movement of goods and factors. Again this requires not only mediation by the centre but also a social consensus on the framework within which economic policy might work at the regional level. In either case, finding a workable set of

incentives involves active consultation between all stakeholders. Indications are that much more could be done in this direction than has been possible till now.

### *Democracy and the place of autonomous institutions*

A final word about the establishment of autonomous institutions to solve the time consistency problem referred to earlier. In Indonesia the pressures come both from the global capital market fearful of policy reversal, as well as from external lenders keen to ensure adherence to contractual commitments. While this strategy may make sense from the point of view of guaranteeing the timely servicing of external debt, it carries the danger of undermining the political transition.

To quote Stiglitz and Stern (1996) again:

“The degree of independence of the central bank is an issue of the balance of power in a democratic society. The variables controlled by the central bank are of great importance and thus require democratic accountability. At the same time the central bank can act as a check on government irresponsibility. The most successful economies have developed institutional arrangements that afford the central bank considerable autonomy, but in which there is a check provided by public oversight, an oversight that ensures the broader national interest is taken into account in the final decisions.”

The establishment of autonomous institutions in democratic societies presupposes the existence of strong oversight mechanisms.<sup>16</sup> In the Indonesian context, where the democratic transition is still in its early stage, the rationale for independent institutions needs to be carefully explained. Failure to do so might well carry the risk of public disillusionment with a reform measure that undermines executive and legislative oversight just at a time when a new democratic state is being created.

### **Conclusion: the Indonesian crisis and the future of development finance**

Crises are not new in economic history. The causes are numerous and range from those triggered by war and plunder or natural disasters to the bursting of speculative bubbles in commodity or real estate markets. In most market economies swings in production have been associated with the operation of business cycles. A considerable body of literature has emerged to understand and manage both output growth as well as its oscillations around a trend.

The recent economic collapse in East Asia signals the arrival of a new kind of economic crisis. This is a crisis triggered by massive outflows of private capital, based on changes not in macroeconomic fundamentals related to any one country but on the loss of investor confidence in a neighbouring country or even

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<sup>16</sup> Indeed this is one of the reasons why reform of the Parliamentary system, including the use of standing oversight committees might well be a pre-condition for the creation of autonomous institutions charged with implementing macroeconomic policy.

a country at the other end of the globe. Moreover, loss of investor confidence might occur even in countries with a sound record of macroeconomic stability and economic growth not over four or five years but over two to three decades. It is ironic that the crisis in East Asia has been most severe precisely in countries with open capital accounts that enjoyed some of the largest inflows of private capital in the 1990s. This included countries, such as Indonesia where a significant share of private capital flows took the form of direct foreign investment.

Indeed, the Indonesian experience brings out an interesting feature of private capital movements, that the loss of confidence associated with sudden flight of short-term capital flows can easily spill over to all forms of capital flows. The fact that external capital inflows contribute only a small share of total savings and investment (as was the case in Indonesia) is also no protection against the havoc that sudden capital flight might wreak. This just goes to illustrate the truth that a small percentage of a large number is still a large number.

The arithmetic of capital flows in Indonesia shows that although external capital in general, and short-term capital in particular, contributed only a fraction of total investment resources, this was not enough to stem the contagion from nearby Thailand. This was initially because these flows were still large compared to the size of Indonesia's foreign exchange reserves. Once the rupiah had started depreciating, the cost of private debt servicing of dollar denominated loans in local currency rose dramatically. This only served to give a further push to the panic already ensuing in currency markets. A final twist was the collapse in the Indonesian stock market as firms teetered on the verge of debt default and bankruptcy.

What has the crisis done to the structure of development finance, and what are the implications for the future? Ironically, as the Indonesian government has tried to override this new type of crisis, having successfully navigated several economic downturns before, it has discovered that foreign aid flows have replaced private flows as the key ingredient of external finance. It has also found that efforts to salvage the banking sector has resulted in a *de facto* re-nationalisation of the banking sector with over 70% of banking assets in the hands of the state.

Much of the explanation lies in the asymmetry between the process of falling into a crisis and emerging out of it. In so far as the latter involves a directing and facilitating role by the state, a collapse in government revenues accompanying the fall in GDP needs to be made up with non-inflationary external finance. Foreign loans and grants are thus the obvious recourse.

However, as the Indonesian example shows asymmetries between the causes and cures of the crisis are not only the result of different speeds with which

different markets and sectors adjust to policy measures, with adjustment in the real sector taking typically longer than that in the macro-economy, they also involve resolution of latent distributional conflicts and institutional reform. The agenda for sustained recovery is therefore more complex and country specific, than existing approaches to structural adjustment would imply. In fact, in the field of governance and institutional reform there are no universal best practices, no single, unique model that suits all circumstances of history and institutional evolution. There are many different types of market economies; many models of capitalism that have at specific times produced equally impressive economic outcomes.

Once we move away from the delivery of economic growth as the driving force of development policy, the choices become even more varied. Institutions and governance structures may then be preferred not just due to their contribution to growth and productivity, but on their impact on the fulfilment of basic human capabilities and rights. As A.K. Sen (1999) observes, the adoption of democracy as a guiding social institution might be justified not only in terms of its impact on economic growth but because “political and social participation has intrinsic value in human life and well-being. To be prevented from participation in political life of the community cannot but be a major deprivation”.

Moreover, the “conceptualisation -even comprehension- of what are to count as ‘needs’, including ‘economic needs’ may itself require the exercise of such rights. Indeed, an adequate understanding of what economic needs are - their content and their force - requires discussion and exchange. Political and civil rights, especially those related to the guaranteeing of open discussion, debate, criticism and dissent are central to the process of generating informed and reflected choices. These processes are crucial to the Formation of values and priorities, and we cannot, in general, take preferences as given independently of public discussion, that is, irrespective of whether open debates and interchanges are permitted or not” (Sen, 1999, p.3).

The entry of institutional reform and the resolution of distributional conflict as essential ingredients into the design of a post-crisis recovery programme points to a different approach to development finance in such situations. First, private and public capital flows need to be regarded not as substitutes but as complementary. The view that public external financial flows must be continually substituted by growing private finance should give way to exploring means of arriving at a judicious partnership between each.

Second, the use of conditionality is a particularly blunt instrument when it comes to the encouragement of governance and institutional reform. This is because there are no universal models and because the process of arriving at the desired institutional choice is key to policy ownership. By their very nature, conditionality to enforce processes is not only likely to be ineffective but might

also be counterproductive, if perceived to be an instrument of external coercion or economic interests.

Third, since public debate is the key to institutional reform, the state can only play the role of a facilitator. Effective policy involves participation of different stakeholders (civil society, government, business and external donors). Both the nature of the partnership between these stakeholders and the framework for their mutual dialogue will have to evolve over time and will vary from one country to another.

Fourth, the example of East Asia shows that even the most economically successful countries have been unable to withstand the onslaught of the global capital market. If we are to avoid such destabilising and expensive events such as the East Asian crisis in the future, in-country economic and institutional reform must be supported by a stable and more discriminating global financial architecture. Simply blaming domestic institutional failures for the crisis misses the point that the world today is a more hostile and less predictable place in which to do business. Unless convinced of the new opportunities created by a more regulated global financial architecture, even the most ardent market-friendly reformers will find themselves looking toward closure of capital market and trade restrictions as the only way out. This will undermine over four decades of post-war economic growth.

**Private & Public Capital Flows to Indonesia**  
(US \$ million)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99 /d
<b>1 Official capital disbursement</b>	<b>5,793</b>	<b>3,519</b>	<b>3,432</b>	<b>5,472</b>	<b>4,575</b>	<b>6,588</b>	<b>5,516</b>	<b>5,006</b>	<b>5,600</b>	<b>5,755</b>	<b>6,195</b>	<b>5,651</b>	<b>5,730</b>	<b>5,298</b>	<b>8,293</b>	<b>16,308</b>
Inflows	5,793	3,519	3,432	5,472	4,575	6,588	5,516	5,006	5,600	5,755	6,195	5,651	5,730	5,298	5,257	9,238
Special assistance	0	0	0	0	0	2,169	1,807	1,542	1,069	886	556	314	205	232	0	0
Program aid /b	84	52	38	48	30	23	6									4,931
Food aid																263
Project aid	4,171	3,137	2,713	3,930	4,338	3,411	2,885	3,387	4,223	4,681	5,239	5,337	5,175	4,666	4,416	3,368
ODA	1,902	1,442	1,332	1,932	2,807	2,406	2,300	2,766	3,165	3,078	3,697	3,662	3,540	2,914	2,454	1,460
Non-ODA	2,269	1,695	1,381	1,998	1,531	1,005	585	621	1,058	1,603	1,542	1,675	1,635	1,752	1,962	1,908
Commercial loan	1,538	330	681	1,494	207	985	818	77	308	188	400	0	350	400	841	676
Exceptional financing															3,036	7,070
IMF															3,036	6,220
Rescheduling															0	850
<b>2 Amortization</b>	<b>-1,010</b>	<b>-1,292</b>	<b>-1,644</b>	<b>-2,129</b>	<b>-3,049</b>	<b>-3,763</b>	<b>-3,686</b>	<b>-4,082</b>	<b>-4,182</b>	<b>-4,840</b>	<b>-5,132</b>	<b>-5,546</b>	<b>-5,939</b>	<b>-6,118</b>	<b>-4,095</b>	<b>-3,747</b>
<b>3 Other capital (net)</b>	<b>1,191</b>	<b>499</b>	<b>572</b>	<b>1,232</b>	<b>1,709</b>	<b>-211</b>	<b>575</b>	<b>5,856</b>	<b>4,133</b>	<b>4,284</b>	<b>4,648</b>	<b>4,645</b>	<b>11,672</b>	<b>13,488</b>	<b>-11,827</b>	<b>-10,181</b>
Direct investment	193	245	299	252	544	585	722	1,424	1,531	1,705	1,971	2,566	5,357	6,546	1,833	114
Others	998	254	273	980	1,165	-796	-147	4,432	2,602	2,579	2,677	2,079	6,315	6,942	-13,660	-10,295

/b Since Quarter I of 1998/99 Program aid has included disbursements of balance of payment support, excluding IMF Loan.

/d Preliminary figures.

Source: Bank Indonesia.

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