

**The United States,
the International Monetary Fund
and the Indonesian Financial Crisis**

John Bresnan

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John Bresnan
Senior Research Scholar
Executive Director, Pacific Basin Studies Program
East Asian Institute, Columbia University



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The leaderless revolution that brought down President Soeharto of Indonesia opened a new era of great challenge to that country and to the United States. The Indonesian revolution left a vacuum of power in the governance of this fourth most populous nation, and a massive task in restructuring its political ideas and institutions. The slow collapse of the old regime left the economy in need of rescuing from approaching disaster. These tasks could be accomplished only with good fortune and generous help.

The United States was in a key position to make a difference in how the international community responded to the new Indonesian situation. It was already enmeshed in the situation. After a long history of assigning a low priority to Indonesia, and a more recent record of consciously distancing itself from that country because of a fund-raising scandal, the United States had thrown itself into the international effort to rescue Indonesia from its financial crisis in October 1997. The crisis spread to every sector of the Indonesian economy, and then turned political as prominent personalities announced a loss of confidence in President Soeharto. Within months of the initial U.S. decision, Mr. Soeharto was ignoring the International Monetary Fund, and the White House was sending former Vice President Walter Mondale to Jakarta to warn that financial support was about to be cut off. Soeharto equivocated, the IMF program was suspended, and funds were withheld.

As prices mounted, and following the shooting deaths of several students and three days of rioting in the streets of Jakarta, major elements in the Indonesian drama avoided the pitfalls into which they might have fallen. The students avoided a further confrontation with the armed forces. The armed forces avoided a further confrontation with civilians. Leaders of large organizations of Muslims counseled moderation. Soeharto resigned. The Vice President who succeeded doubtfully to the presidency reached out to reformists. There was a widespread appreciation of the precarious nature of political and social cohesion, and a generalized disposition to speak in measured terms. The Indonesians had experienced a miracle. Now they needed two more. They had to put in place a new regime with broad-based legitimacy. And they had to arrest the continuing downward spiraling of the economy that threatened to bring social relations to the point of boiling over in mass violence. Aid from abroad was needed, and needed urgently.

This paper attempts to answer several questions about the Indonesian crisis and the responses of the United States and the International Monetary Fund. Was the United States right to intervene in the first place? Did the IMF have the right remedies for Indonesia's problems? Did the United States play an appropriate role vis á vis the IMF and the Indonesians? Especially, in light of what followed, should the United States have tried to bring Soeharto down earlier? What implications did the experience have for future U.S. policy? The paper proceeds chronologically from October 1997 to June 1998, with stops at points along the way to assess the Indonesian, U.S. and IMF performances. Larger strategic issues are then considered, and a final section takes up issues facing U.S. policy in the future.

The U.S. Intervention

One has to go back more than three decades to find a time when a president of the United States intervened in Indonesia's affairs with an action comparable to that taken by President Clinton in February 1998. In the early 1960s, Presidents John F. Kennedy and Lyndon Johnson both sent Robert Kennedy, then Attorney General of the United States, to Jakarta to try to change the mind of President Sukarno, first to end his threat to invade Western New Guinea, and then to end his "confrontation" against Malaysia. Neither mission was successful.

In early 1998, geopolitics had been replaced by geoeconomics in East and Southeast Asia. The enemy facing the United States was not a foreign military power but a roiling of the financial markets. The panic that started in Bangkok on July 2, 1997, with the floating of the Thai baht, was spreading throughout the region. On October 26, Secretary of the Treasury Robert E. Rubin ruled out an Asian bailout led by the United States. He had reason to do so. The \$40 billion bailout of Mexico in 1994, which was led by the United States and supported by the International Monetary Fund, had been highly controversial. Now, legislation was pending in Congress to replenish the IMF and pay arrearages due the United Nations, two politically sensitive objectives that were high priorities of the Clinton administration. Also pending was legislation to extend the President's "fast-track" authority to negotiate international trade agreements, which was being sought in order to expand the North American Free Trade Area southward beyond Mexico. Mr. Rubin had strong grounds for avoiding anything that might be seen as a repetition of the Mexican experience.

Events did not permit Mr. Rubin to take a back seat in the Asian crisis as he had hoped. On October 27, the day following Mr. Rubin's statement ruling out an American-led bailout, stocks on Wall Street fell 554 points, or seven percent, the 12th worst day on record, forcing a suspension in trading.¹ The tremors were felt worldwide; prices dropped in Hong Kong, Japan and Europe, fell further a day later in New York, and then hit the markets in Brazil and Argentina. The panic was widening -- and quickly. On October 30, the Treasury let it be known that the United States would commit \$3 billion as "a second line of defense" in support of a plan, led by the International Monetary Fund, to rescue the Indonesian economy. U.S. officials pointed out that the roles were reversed from the Mexican case. They also called attention to the expectation that the Fund's money would come with strings attached, including measures that would prove painful for the family of Indonesia's president. U.S. officials also said it was not expected that

¹Floyd Norris, "Stocks Fall 554 Points, Off 7%, Forcing Suspension in Trading: 12th Worst Day: Hong Kong Plunges at Opening and Tokyo is Down at Midday," *The New York Times*, October 28, 1997.

Indonesia would actually need to draw on the U.S. commitment. "What we need to address here," a senior U.S. official said, "is an atmosphere of contagion."²

Thus, the United States got out in front of the International Monetary Fund in spite of its original intention not to do so. The formal announcements by the Fund and the Treasury came on October 31. Mr. Rubin's statement said: "Financial stability around the world is critical to the national security and economic interests of the United States. These countries are not only key markets for U.S. exporters, but are also crucial to our efforts to promote growth, peace and prosperity throughout the world." And, indeed, officials were telling the press again that the immediate objective of the American action was to arrest what the Treasury was calling "market contagion" -- "the odd ways in which a loss of investor confidence in one nation spreads to others."³

There was a significant regional dimension to the U.S. decision to participate in the intervention in Indonesia. The United States had remained on the sidelines when the International Monetary Fund mobilized \$17 billion to rescue the Thai economy in August 1997. The absence of the United States from the group of lenders was widely criticized in Asia, and the Thais themselves were shocked at what they saw as the failure of a long-time ally to come to their aid. It was a strategic error on the part of the United States, and the crisis was not contained.

When the decision on Indonesia was confronted, the "contagion" was in full flood. The White House and the State Department, as well as the Treasury, were seized with the issue. Indonesia was seen as fundamentally sound, already taking significant steps to calm its markets, and turning to the IMF as a confidence-building measure. Moreover, Widjojo Nitisastro, the chief architect of the Soeharto era's long run of rapid economic growth, and well known to the international financial institutions, was selected by President Soeharto to be the lead Indonesian negotiator, although his role was limited in the first round. Indonesia also bulked very much larger than Thailand. Its population of 200 million was the fourth largest in the world, its pre-crisis economy was the largest in Southeast Asia, and U.S. economic interests there were the largest in the region as well. Indonesia also was politically *primus inter pares* of the nations of the region; its support was essential to any serious undertaking in Southeast Asia. Indonesia

²David E. Sanger, "U.S. Is Set To Lend \$3 Billion To Help Bolster Indonesia: Many Strings Attached: International Monetary Fund Is Committing \$15 Billion To Spearhead Bailout." *The New York Times*, October 31, 1997.

³David E. Sanger, "The Economic Stakes in Asia: Clinton Hopes \$3 Billion for Indonesia Will Help Dull Panic," *The New York Times*, November 1, 1997.

under Soeharto had played a helpful role in seeing to it that the first organization of the nations of East Asia in history (the Asia Pacific Economic Cooperation forum) would include the United States, rather than, as Malaysia was urging, exclude it. Indonesia had played significant roles in any number of other regional disputes, including Cambodia and the South China Sea. Moreover, no China policy was thinkable without the balance that a strong Indonesia brought to regional affairs. But an Indonesia in disarray could be a danger to the region, as was at this very time physically evident across much of Southeast Asia, where a haze created by hundreds of Indonesian forest fires was threatening the health and economies of a half-dozen countries. There was every reason for Mr. Rubin to invoke as he did the national security, as well as the economic, interests of the United States.

Whether the United States was right to intervene in Indonesia could not be determined immediately, however. That depended on whether the intervention would be effective. And that depended in turn on whether the IMF had the right remedy, and whether Mr. Soeharto would take the medicine the IMF prescribed.

The Right Remedy?

The details of the letter of intent addressed to the IMF by the government of Indonesia on October 31, 1997 were not known at the time. The IMF did not make the document public, and the government of Indonesia did not do so either. It was understood that the agreement was brief, and that it called for the closure of banks that were over their heads in debt and for the government to reduce spending. Two lines of criticism arose immediately.

Jeffrey D. Sachs, director of the Harvard Institute for International Development, said the problems of the Southeast Asian economies were not the same as those that the IMF had dealt with in the past, typically in Latin America, and the remedies the IMF had developed out of that experience did not apply. Mr. Sachs argued in an article in *The New York Times* that "the IMF's usual target is a government living beyond its means, financing budget deficits by printing money at the central bank." In Southeast Asia, the situation was different. "Indonesia, Malaysia, the Philippines and Thailand have all been running budget surpluses, not deficits. Inflation has been low for all of the countries. Foreign exchange reserves, until this past year, were stable or rising, not falling." What happened was that "international money market managers and investment banks went on a lending binge from 1993 to 1996. To a varying extent in all of the countries, the short-term borrowing from abroad was used, unwisely, to support long-term investments in real

estate and other non-exporting sectors. This year, the bubble burst."⁴

In these circumstances, the IMF was administering the wrong medicine, Mr. Sachs said. It was pressing the Asian countries to raise existing budget surpluses still higher and to tighten domestic bank credit. And in a move that was supposed to engender confidence but almost surely would do the opposite, Mr. Sachs said, the IMF had called on Thailand and Indonesia to close a number of weak banks that had been caught up in the boom-bust cycle of foreign lending.

Events seemed to prove Mr. Sachs right. On November 1, the government of Indonesia announced the closure of 16 banks, and touched off a run on all domestic private banks as depositors sought safety elsewhere. It was widely expected that more banks might be closed, and the public did not believe the government when it denied that this was so. The result was to dry up a large share of the domestic credit supply, which had a particularly negative impact on small- and medium-scale business. (The government of Thailand closed the 56 financial institutions without generating a bank panic, but the closed institutions were not banks holding depositors' money.)

The IMF also appeared to acknowledge the aptness of the Sachs argument against constricting public spending in circumstances of deflation. In a matter of months, the Fund eased the budget terms imposed on both Thailand and Indonesia, permitting them to run budget deficits instead of holding them to surpluses.

Off the record, Fund officials acknowledged that they were dealing with a new phenomenon, and conceded that they were groping for an appropriate response. Apparently the U.S. Treasury was doing the same. In addition, the Fund and the Treasury had little or no Indonesian expertise in their staffs. This dearth of country-specific knowledge was to continue to plague both the Fund and the U.S. as time passed and negotiations reached more deeply into Indonesia's affairs.

Some observers in the private markets in Jakarta took a different tack from the Sachs critique, arguing that the letter of intent did not go far enough in demonstrating that President Soeharto was prepared to sacrifice the interests of his family and friends. It was noted that the agreement with the IMF did not deliver a *coup de grace* to the controversial national car project in which President Soeharto's son Hutomo (Tommy) Mandela Putra had an interest. The agreement also did not provide for an end to government subsidies to such state-owned enterprises as the aircraft maker Industri Pesawat Terbang Nusantara, the pet project of

⁴Jeffrey D. Sachs, "The Wrong Medicine for Asia," *The New York Times*, November 3, 1997.

Bacharuddin Jusuf Habibie, a Soeharto intimate, although the matter was to be reviewed.⁵ Such reforms would not directly affect the flow of capital in the near term. But the cases were prime examples of the corruption and nepotism that were part of the problem in the first place. If they were untouchable, analysts reasoned, it was doubtful that Mr. Soeharto would be willing to take any of the other hard decisions that resolving the financial crisis would require.

The United States at this point took a low profile position on the Indonesian crisis. President Clinton might have made the U.S. position clear when he met privately in Vancouver with President Soeharto on November 24, but apparently Mr. Clinton did not do so. Many observers were perplexed by the inchoate character of U.S. policy. Nayan Chanda, editor of the *Far Eastern Economic Review* and earlier its correspondent in Washington, wrote at about the time of the Vancouver meeting that Bill Clinton "has been a distant president for most of Asia and for Southeast Asia in particular." To begin with, "most of Asia's elite have always shown Republican sympathies." Unlike George Bush, who was a familiar figure in Asia before becoming president, the former governor of Arkansas was largely unknown, and "many in Asia saw Clinton's election as a recipe for trouble."⁶ Mr. Clinton's "retreat from leadership" was particularly pronounced in his handling of relations with Indonesia: "Paralyzed by the charge that an Indonesian businessman had bought influence in the White House, Clinton let relations fester. In protest against the administration's criticism of its human rights policy, Jakarta canceled an agreement for military cooperation with the United States and an order for F-16 fighters. Not until Mr. Clinton's belated appointment of Stanley Roth as assistant secretary of state for East Asian and Pacific affairs and Roth's forceful advocacy of a more proactive policy toward Indonesia did Clinton attempt to halt the slide."⁷ Perhaps it was the combination of Mr. Clinton's unaccustomed reticence in the midst of his domestic scandals and the well-known reluctance of his Treasury secretary to speak his mind that resulted in an American leadership in the currency crisis that was markedly lacking in an ability to communicate to the public what it was doing and why.

Thus the first round of negotiations on the Indonesian rescue left much to be desired. The

⁵John McBeth, "Big is Best: Indonesia's rescue package draws on the Thai experience," *Far Eastern Economic Review*, November 13, 1997, pp. 68-69.

⁶Nayan Chanda, "A View from Asia," *Foreign Policy*, Winter 1997/98, p. 66.

⁷Ibid, pp. 67-68

IMF was unprepared to deal with the potential ravages of short-term capital movements in the new era of deregulation. The Treasury did not seem to have an independent view of how to proceed. Neither the Fund nor the Treasury was ready to deal with Indonesia. And the White House was not seriously engaged.

The Problem Denied

Following the closure of the 16 banks in early November 1997, an unnatural quiet prevailed in Jakarta. It was as though there was no crisis; for two entire months, no initiatives were forthcoming from the Indonesian government. The principal development was the absence of President Soeharto, with an unexplained illness, from the December summit of East Asian leaders in Kuala Lumpur, Malaysia, held to mark the thirtieth anniversary of the Association of Southeast Asian Nations. Indeed, Mr. Soeharto appeared in public only rarely during this period, raising mounting fears that no one was in charge. At the end of December, the International Monetary Fund was reported to have sent him a strongly worded letter urging that the Indonesian government begin to carry out promised policy changes.

Then in early January 1998 the Indonesian president administered a shock to the financial markets; he announced a budget for 1998-99 that was widely viewed as overly optimistic. Indonesia's currency and stock markets suffered their worst one-day losses ever, and there was panic buying in the shops, set off by fears that the International Monetary Fund would cut off its assistance. At the same time on Wall Street, amid expectations that American corporations would increasingly feel the pinch of a slowdown caused by the deterioration in Asia, the Dow Jones industrial average fell 2.85 percent in one day, its sharpest drop since the plunge in October. In one week, stocks fell 14 percent in Hong Kong, 23 percent in Singapore, and 19 percent in Manila. Alarm bells were ringing again in Washington and other capitals.

President Clinton telephoned Mr. Soeharto on January 8 while flying in Air Force One from Washington to Texas. Mr. Clinton made it "quite clear that the IMF program has to be followed," according to a senior Administration official, and told Mr. Soeharto that he was sending a delegation of senior officials to the region in the next several days, led by Lawrence H. Summers, Deputy Treasury Secretary. In addition, Defense Secretary William S. Cohen also would be stopping in Indonesia in a week, on a previously scheduled tour.⁸ Prime Minister Goh Chok Tong of Singapore, whose government had matched Japan with a commitment of \$5 billion in support of the IMF program, also paid a personal visit. Pressure on Mr. Soeharto also came in the form of telephone calls from, among others, Prime Minister Ryutaro Hashimoto of Japan and

⁸David E. Sanger, "Clinton Phones Suharto, Insisting on Commitment to IMF Plan," *The New York Times*, January 9, 1998.

Chancellor Helmut Kohl of Germany, who emphasized the importance of conforming to IMF norms.

Stanley Fischer, the senior deputy head of the International Monetary Fund, said on CNN that the Fund would "like to accelerate the program and strengthen it, because a lot of people believe the Indonesian government isn't really committed to the program."⁹ Mr. Fischer pointed out at a workshop in Washington that, of the Indonesian banks that had been closed, two of interest to Soeharto family members were back in business in a matter of days. A confidential IMF report distributed to members castigated the Soeharto government for failure to enact the reforms it had promised in exchange for international funding. Within days of signing the October 31 letter of intent, the Fund report said, economic reforms seemed to have disappeared from the Indonesian government's agenda. Criticism also came from Sumitro Djojohadikusumo, the founder of modern economics in Indonesia, and father-in-law to a Soeharto daughter. Professor Sumitro called reporters in to hear him speak bitterly of the "corruption and excessive protectionism" that was now a burden on the economy. He called on the cabinet to resign.¹⁰

Under this intense pressure, most of it from abroad, and a notable share of it from the United States, President Soeharto on January 15 personally signed a new letter of intent that called for a wide-ranging program of austerity measures aimed at halting the slide of the Indonesian economy. As he did so, IMF managing director Michel Camdessus stood at his elbow, arms folded, looking every bit the schoolmaster he was playing in the Indonesian drama. The photograph of this scene became a symbol of the highly charged issue that lay at the heart of the negotiations -- whether the IMF, and through it the United States, had the right to dictate terms to the Indonesian government in return for help in restoring confidence in its economy.

The agreement ran to fifty numbered paragraphs.¹¹ The principal expectation was that the economy would register zero growth in 1998-99. The government budget, rather than run a surplus of one percent of GDP, could run a deficit of one percent of GDP, thus allowing for increased spending in the economy. Subsidies were to be reduced, however, and prices increased

⁹Seth Mydans, "Markets Tumble And Rumors Sweep Indonesia Capital: Panic Buying In Shops: Fears of IMF Aid Cutoff Stir Talk of Political Instability and Suharto Succession," *The New York Times*, January 9, 1998.

¹⁰David E. Sanger, "Indonesian Leader Yielding To Pleas To Mend Economy: Series of Official Visits; Suharto Assures U.S. He Will Observe Terms of a Bailout --Skepticism Persists," *The New York Times*, January 13, 1998.

¹¹The following account is drawn from "Isi Nota Kesepakatan IMF-Pemerintah Indonesia (Contents of the IMF-Government of Indonesia Agreement)," *Kompas*, January 16, 1998.

for food and fuel.

Much attention was paid to the numerous structural reforms, which appeared breathtaking to many observers for the extent to which they would reduce the wealth and power of Soeharto family members and associates if carried out. Budget and off-budget funding of the aircraft manufacturer IPTN was to be halted. Every form of support was to be withdrawn from the national car project. Bank Indonesia, the central bank, was to be given full autonomy to set monetary policy and interest rates. Effective February 1, the monopoly of the Logistics Agency was to be restricted to rice; the monopoly importation and distribution of sugar and wheat flour were abolished. The body controlling the marketing of cloves would be abolished by June 1998. The cartels controlling the marketing of cement, paper, and plywood were abolished effective February 1. Control of foreign investment in palm oil production was abolished. Regulation of retail trade was abolished.

Early reactions to the agreement focused on the extent of the changes Mr. Soeharto had agreed to and the question of whether he would carry them out. Mohammad Sadli, an Indonesian economist and former cabinet minister, wrote that the agreement "exceeds the wildest expectations of economists and other intellectuals who had demanded reforms during the past few years but could not get very far against an overwhelmingly strong government bent on keeping the status quo." But there were political uncertainties as well -- the issue of who would succeed Soeharto and when, and whether President Soeharto would now become a force behind implementation of the agreement. Sadli saw a skeptical market refraining from a strong vote of confidence.¹²

On January 20, five days after the IMF signing, President Soeharto proved the skeptics right. He let it be known that he was ready to serve a seventh term in office, and gave a strong indication that his candidate as his next vice president and potential successor was B. J. Habibie, the long-time cabinet favorite and family friend, best known for his eccentric economic policy views and his championing of extravagant high-technology projects. On January 21 the value of the rupiah fell 15 percent, and on January 22 fell at one point as much as another 23 percent. Having been at 2,400 to the dollar the previous July, the rupiah went all the way down to 17,000 to the dollar, making it the world's worst performing currency. The market, it seemed, did not like Indonesia's prospective leadership.

¹²Mohammad Sadli, "Letter From Jakarta: The New IMF Agreement: A Necessary but Not Sufficient Condition for Exchange Rate Stabilization," *Indonesia in the United States: A Newsletter of the United States-Indonesia Society*, (Washington, D.C.: U.S.-Indonesia Society, Winter 1998), pp 4-5. The Newsletter states the Letter was received January 19, 1998.

The issue of presidential succession had been raised with Mr. Soeharto by Mr. Camdessus. It is likely that Mr. Camdessus limited himself, however, to suggesting that an early indication of Mr. Soeharto's plans would be helpful in calming the markets. U.S. Treasury opposition to Mr. Habibie was well known. Treasury officials were said to have been threatening to cut off U.S. support altogether if Mr. Habibie were made vice president. Was Mr. Soeharto deliberately challenging the United States? One Soeharto confidant, no friend of Mr. Habibie, said that the Americans themselves were responsible for his advancement; by opposing him so strongly, they had given Mr. Soeharto reason to prefer him. But this was only part of the story. Mr. Soeharto had always sought balance. Having been pushed very hard by Professor Widjojo to agree to the reforms in the IMF program, it was characteristic that he would then choose a man who stood for big government as his vice president. Moreover, while Mr. Habibie was not well regarded by the Americans, he was well thought of in Germany, where he had been educated, and in Japan, where his preference for protectionist policies was accepted. In addition, Mr. Habibie had no political base of his own; his only support was the president himself; so he was no threat to Mr. Soeharto. And Mr. Habibie had no support in the Indonesian army; the fact that he would succeed to the presidency, at least temporarily, would help forestall any potential attempted coups. Mr. Soeharto had preferred Mr. Habibie in order to protect himself. He probably did calculate that the U.S. Treasury was bluffing, or that it would not lead the United States government as a whole to cut Indonesia off. If so, he gambled that Indonesia was too important, and he won.

Direct Political Action

The January agreement was too good to last. Perhaps his children convinced Mr. Soeharto that Professor Widjojo was wrong in arguing that the economy was in grave peril. Or perhaps he was shocked to discover that his signing the agreement was widely seen as capitulation to the IMF. Whatever the reason, having signed the agreement, Mr. Soeharto took no vigorous steps to implement it. On the contrary, the one economic issue that he attended to was the low state of the Indonesian rupiah, which -- probably with central bank support in conflict with the IMF agreement -- was hovering in the vicinity of 10,000 to the dollar.

The solution that captured Mr. Soeharto's enthusiastic interest was creation of a currency board that would limit the domestic money supply to the country's foreign-currency reserves at a fixed rate of exchange to the U.S. dollar. A proponent of the idea, Steve Hanke, a professor of applied economics at Johns Hopkins University, reportedly was introduced to Mr. Soeharto by his eldest daughter, Siti (Tutut) Hardiyanti Rukmana. The central bank and the finance ministry learned about the plan through the newspapers. So, apparently, did the IMF and the U.S. government. According to a senior economic adviser to Mr. Soeharto at the time, the Indonesian president was determined to avoid bowing to the IMF demand to close down the projects of his family and friends, which he saw as a challenge to his personal authority.

Michel Camdessus made his annoyance plain by making public the fact that he had written Mr. Soeharto to say that, if the government of Indonesia were to set up a currency board, "we would not be able to recommend to the IMF board the continuation of the present program because of the risks to the Indonesian economy." Not mentioned was the additional concern, widely commented upon, that a currency board might strengthen the rupiah just long enough for Mr. Soeharto's children and friends to convert their assets into dollars at a favorable rate and move the money out of the country, which by itself would torpedo international support.

President Clinton telephoned President Soeharto yet again, stopping just short of threatening a cut-off of aid if the currency plan went ahead.¹³

In this environment, with Mr. Soeharto toying with the currency board idea, and the IMF program in Indonesia at risk, the White House decided to send former Vice President Walter Mondale to try to "get through" to Mr. Soeharto. President Clinton had telephoned the Indonesian president twice in one week to ward off his making a commitment to the currency board idea. He had by now made four calls to Mr. Soeharto, and they were described by one senior official as "unsatisfying at best." The January face-to-face meeting of Mr. Summers with Mr. Soeharto had been a 90-minute monologue by the Indonesian president -- "classic Soeharto," one official called it. Late in February Secretary Rubin acknowledged, "We are still trying to send the message to Indonesia that it is in their overwhelming interest to implement the reforms to keep Indonesia from dissolving into further financial chaos." And the IMF was already easing its terms, agreeing that the Indonesian government should continue to subsidize foodstuffs to keep their prices from continuing to rise. "We have no wish to see food riots," a Fund official said.¹⁴ In addition, there were rumors that Mr. Soeharto was preparing to dismiss most of his economic team and replace them with close friends who were assumed to be hostile to the IMF terms.

Mr. Mondale was less than an ideal candidate for the mission. The obvious arguments in support of his selection were that he was himself a distinguished elder statesman and, as a former U.S. ambassador to Japan, well able to express himself in the indirect, refined language preferred by the Indonesian president. The weakness in Mr. Mondale's candidacy was that Mr. Soeharto did not know him; they had met only once, twenty years before. However, there really was no strong alternative. Very few Americans were well known to Mr. Soeharto, and each of these was ruled out for one reason or another. Surprisingly in the circumstances, Mr. Mondale was given an

¹³David E. Sanger, "Clinton Tells Indonesia to Stick to Reform," *The New York Times*, February 15, 1998.

¹⁴"Mondale to Visit Jakarta to Press Suharto on IMF Reform Plan: Ex-Vice President's goals: to offer help and re-establish a dialogue," *The New York Times*, February 25, 1998.

added assignment in the final preparations for his mission. He was not only to urge Mr. Soeharto to accept IMF opposition to the currency board but also to deliver a political message to Mr. Soeharto: "that he must choose his next Cabinet carefully, avoiding longtime cronies, and create an economic team that the markets will perceive as willing to work with the IMF program."¹⁵ However, in spite of this ambitious agenda, the Mondale mission probably was not expected to be much of a success, but was designed to show that the United States had taken every reasonable step to persuade Mr. Soeharto before suspending the pay-out of IMF funds, with repercussions in Indonesia that could not be predicted.

Mr. Mondale had a 90-minute meeting with Mr. Soeharto on March 3. The former American vice president is reliably reported to have dropped on his own authority the issue of Indonesian cabinet appointments, on the ground that this would weaken the impact of his primary message of support for the IMF. As it was, Mr. Mondale "got nothing but a polite reception," as one source put it. Hours later, Lawrence Summers of the Treasury told members of the Senate that the White House could not support additional aid to Indonesia from the IMF unless Mr. Soeharto made "adequate progress" on reforms agreed to in January. There was nevertheless hesitation in Washington out of fear that any new outbreak of violence in Indonesia would be blamed on the Fund and the United States. The same day that Mr. Summers delivered his public threat, Robert Rubin took a different tack in responding to questions from a second Senate committee: "The IMF faces a very difficult issue. On the one hand, it seems to me that you do have to have compliance with their conditions if they're going to release (the next \$3 billion in funds). On the other hand, I don't think any of us should have illusions about the seriousness of this decision because Indonesia is in a very difficult situation, and there are all sorts of very serious consequences that can come from that." This is, Mr. Rubin said, "a very grave moment" in Indonesia.¹⁶

That same day, Bank Indonesia reported foreign reserves were \$16.3 billion, down 25 percent from the close of 1997. The year-on-year inflation rate in February was 31.7 percent, nearly double the rate in January. The rupiah was trading in the vicinity of 9,000 rupiah to the dollar.¹⁷ Foreign sources in the banking industry said the central bank was flouting reforms sought by the IMF by pumping funds into inefficient local banks to keep them alive. If the closing

¹⁵Ibid.

¹⁶David E. Sanger, "U.S. Is Linking Aid to Jakarta To its Reforms," *The New York Times*, March 4, 1998.

¹⁷Agence France Presse, March 3, 1998.

of 16 banks in November was too hasty, the effort to keep the rest alive was proving much too costly.

On March 6, 1998, the IMF issued a statement saying that it was delaying the infusion of \$3 billion scheduled for March 15 because the "basic conditions" had not yet been met. The decision would delay the money's transfer at least until April after discussions with Indonesia's new cabinet.¹⁸

As scheduled, on March 11, President Soeharto was unanimously re-elected to a seventh five-year term in an impressive display of his personal control of the formal levers of power, and B.J. Habibie was elected Vice President. On March 14, Mr. Soeharto announced his cabinet, which confirmed the rumors that had preceded the Mondale visit. Minister of Finance was Fuad Bawazier, a former tax official who was known as an associate of Mr. Soeharto's children. Minister of Trade and Industry was Muhammad (Bob) Hasan, the head of the plywood cartel and Mr. Soeharto's golfing companion. Minister of Social Affairs, charged with overseeing relief, was Siti (Tutut) Hardiyanti Rukmana, Mr. Soeharto's eldest daughter.

Was the cabinet intended as a snub to the IMF and the United States? A senior IMF official observed that the Indonesian president was saying, "I'll do it my way." But the cabinet was principally a statement that Mr. Soeharto was showing his age, retreating further into a small circle of family and friends, people he felt comfortable with, people he thought he could trust. That last was the only positive thing one could say about the new cabinet. It was the least competent Soeharto cabinet so far. The new line-up left the government of Indonesia to deal with international forces that neither its president nor his cabinet understood very well. And it left the government without lines of communication to key domestic constituencies.

A month after the new cabinet was installed, and three weeks after the arrival of IMF negotiators, the cost of Mr. Soeharto's despatch of his experienced economic advisers was becoming evident. Agreement was reached on April 8 on a third IMF agreement, which included a long list of commitments complete with target dates for action. An American official said there would be "step-by-step monitoring." To assure compliance, the Fund would withhold the dollars committed to Indonesia until the Indonesian government took a series of steps it had so far resisted. Then, it was reported, the Fund would transfer funds in small amounts as the government acted on its commitments. Mr. Soeharto's new government was being put on a short

¹⁸Seth Mydans, "IMF Delays Indonesian Aid; Reforms Seem to Be Stalled: The currency is taking a beating. So is President Suharto," *The New York Times*, March 7, 1998.

leash.¹⁹

The Indonesian president did not have much choice by this time. As the third IMF agreement was nearing completion, the Fund expected Indonesia's economy to shrink by five per cent in calendar 1998, compared with the January expectation of zero growth. Inflation was expected to average out at 47 per cent in 1998, compared with a January expectation of 20 per cent.²⁰ Meanwhile the newly unemployed in Indonesia were estimated at 5.5 million, and were expected to reach between eight and nine million by the end of 1998. In addition, the underemployed, who numbered 41 per cent of the work force of nearly 90 million in 1996, were expected to increase drastically.²¹ Up to this point, student protests were limited to university campuses, but they were becoming more violent. If they moved off the campuses, where they could be joined by unemployed youth, the level of violence would be ratcheted sharply upward.

Two issues were central to the third round of IMF talks. One was the restructuring of the domestic banking industry. The other was the resolution of the foreign debt of Indonesia's private corporations. The collapse of confidence in the domestic banks, and the inability of Indonesian corporations to repay their debts to foreign banks, had been the earliest outcomes of the crisis.

What was happening in regard to the domestic banks was not entirely clear. In agreement with the IMF, the Indonesian Bank Restructuring Agency had been created in January to take over control of banks that were seriously over-extended. By early April the IBRA had taken 54 banks under close supervision; some 250 bank examiners were placed in these banks to monitor compliance with restrictions on new credits and payments of dividends. In late April the rating service Standard & Poor's put the amount of cash put into the banks in the form of low-interest loans at \$10 billion. While 23 banks had been closed in the previous six months, 200 or more were still operating, and analysts believed that most of these would not be viable. S.&P. estimated that nonperforming loans would reach 55 percent nationwide by the end of the year.²² Apparently no one in the central bank was prepared to take on the well-connected owners of the

¹⁹David E. Sanger, "After Compromises, Indonesians Reach 3d Pact With IMF," *The New York Times*, April 8, 1998.

²⁰Jay Solomon and I Made Sentana of Dow Jones News Wires, with contributions by Kate Linebaugh, "Tentative IMF Deal Lifts Hopes That Rescue Will Resume," *The Asia Wall Street Journal Weekly Edition*, April 6, 1998.

²¹Richard Borsuk, "Millions in Indonesia Lose Jobs and Poverty Ranks Grow," *The Wall Street Journal Weekly Edition*, March 30, 1998.

²²Bloomberg News, "S.&P. Assails State of Indonesian Banks," *The New York Times*, April 30, 1998.

private banks. This was markedly unlike the situation in Thailand and Korea, where new governments were dealing with their financial institutions with a good deal more authority. The banking sector of Indonesia cried out for a new government with the ability to take firm action.

Resolution of the foreign indebtedness of Indonesia's private corporations was no less important -- the key to restarting the flow of foreign capital. This indebtedness was reported by Bank Indonesia to total \$80.2 billion as of April 3, 1998. At prevailing rates of exchange, the Indonesian firms could not or would not pay their debts. Steering committees of representatives of the Indonesian corporations and the foreign banks had been meeting in Singapore and elsewhere in search of a solution to the problem. The IMF, perhaps with an eye to the free-market lobby in the United States, did not make the resolution of this indebtedness a formal part of its discussions with the government of Indonesia until the negotiations leading to the third agreement. By this time the IMF could not avoid concluding that the government of Indonesia had to take an active role if the problem was to be solved. Various sources were reported as saying that talks were centered on a broad "framework" that would include features of a model used in Mexico, calling for the government to sell foreign exchange to debtor corporations at a pre-determined rate for the exclusive purpose of repaying their foreign debt, thus enabling individual creditors and debtors to proceed on a case-by-case basis. But a full-fledged plan to deal with the foreign private debt problem was thought to be weeks or months away.

Thus the capacity of the IMF to deal with the financial institutions that were centrally involved in the crisis was still in some doubt, and implementation of the IMF program by the Soeharto government was at a virtual standstill. Mr. Soeharto had ignored the existence of a crisis after reaching the first agreement with the IMF. He had tried to blackmail the IMF with the currency board scheme rather than implement the second agreement. Now a month had been taken up with negotiating the third agreement with a new Indonesian team. Five months had passed, and there was little in the way of results to be seen, except the continued downward spiraling of all the economic indicators.

Frustration and Fall

The IMF agreement of April 8 provided for a massive intrusion into the governance of Indonesia. It was more readily compared to Fund dealings with post-Communist Russia than to those with Latin American countries. More than 100 policy reforms had target dates for action. A monitoring system was to be established to track structural reforms. The ineffective bankruptcy law was to be amended and a special court established to deal with claims. Seven state enterprises were to be privatized within a year. Monetary data were to be published on a weekly basis. Restrictions were lifted on foreign investment in the wholesale trade. The list ran

on and on.²³

By this time the level of frustration among officials dealing with Indonesia in the U.S. government was very high. Treasury officials urging that Congress approve an additional \$18 billion for the IMF were criticized fiercely at a House Banking subcommittee hearing on April 21 for "funding a vicious dictator."²⁴ Indonesia certainly stood out in the Asian crisis, and many officials had to have been deeply dismayed by the resistance they were experiencing from the Soeharto government. Mr. Soeharto was saying there could be no political change until the year 2003, while new leaders in Thailand and South Korea were strengthening democratic institutions at the same time as they pursued economic reforms. U.S. officials rightly worried that they were increasingly seen as propping up the Soeharto dictatorship by continuing economic aid. And it also was possible that the whole IMF effort could collapse if the rising criticism by students in Indonesia burst beyond the campuses and the military took violent means to repress them. But the alternative was to deny the aid, further imperil the lives of Indonesians, and contribute directly to a mass outbreak of violence. "The Indonesian people -- particularly the poorest -- have a tremendous interest in seeing financial stability restored," David Lipton, the under secretary for international affairs at Treasury, said. "And so do we."²⁵

It was not to be. On May 4, the Soeharto government announced a reduction in fuel subsidies that meant an immediate increase of 70 percent in the price of gasoline. Coming on the heels of 33 percent inflation since January, the price increase by the wealthy and corrupt state oil company led immediately to more radical student protests. In the city of Medan in North Sumatra, thousands rampaged through the streets for three days, after which students began to move beyond their campuses in Java. The price rise was a fateful decision. The IMF had pressed for an end to the subsidies by October but gave the Indonesian government leeway to go about it as the government thought best. Most sources agree that Mr. Soeharto approved the

price increase personally; that he was overconfident seems plain. Only hours after the announcement in Jakarta, the IMF released the long-delayed first tranche of \$1 billion.

The United States responded to developments in Indonesia on May 8 following a meeting

²³David Sanger, "After Compromises, Indonesians Reach 3d Pact With IMF," *The New York Times*, April 8, 1998.

²⁴David Sanger, "IMF Loans to Rights Violators Are Attacked in Congress," *The New York Times*, April 22, 1998.

²⁵David E. Sanger, "The Indonesian Tangle: How It Enmeshes the U.S.," *The New York Times*, May 6, 1998.

at the White House. The Export-Import Bank approved loan guarantees worth \$1 billion to enable Indonesian factories to buy American materials they needed to begin working again. At the same time, the Pentagon canceled a joint training exercise with the Indonesian armed forces. That joint military exercises were still taking place as late as May 8 was surprising in the circumstances. The United States had circumstantial evidence that elements of the Indonesian armed forces were kidnapping and torturing political dissidents. The U.S. ambassador to Indonesia, J. Stapleton Roy, had called on several Indonesian army leaders to express his concern about these reports as early as late February. In the weeks that followed, at least four of the young activists were transferred to police custody. It is an indication of the considerable caution with which Washington was dealing with Mr. Soeharto that it did not earlier break off ties with the Indonesian armed forces. The chief suspect in the disappearances was Major General Prabowo Subianto, a son-in-law of Mr. Soeharto, and a potential future power-holder himself.

By this time, thousands of students were battling with the police and military in cities and towns in many parts of Indonesia, and calling for Soeharto to step down. In testimony before the House Foreign Relations Committee on May 10, Assistant Secretary of State Stanley Roth said, "We have repeatedly raised our concerns at high levels within the government and have made clear our expectation that peaceful demonstrations be allowed to continue."²⁶

Then on May 12, the flashpoint was reached that the Soeharto government had so far avoided: security forces in Jakarta shot and killed four students and wounded at least a dozen others when they fired live ammunition at demonstrators who spilled out of a college campus onto a major highway. Concerned that the United States was still too closely identified with the Indonesian president, the State Department issued a statement that deplored the killings and for the first time agreed with the critics that Indonesia was in need of "political reform."

What followed in Jakarta is no doubt already familiar to the readers of this volume: the outpouring of anger over the student deaths, and the chaos of rioting, looting and burning (and, as later came out, raping) that engulfed the city on May 13, 14 and 15, with the loss of something on the order of 1,200 lives. In England for a meeting of the G-8, President Clinton said: "I strongly urge the Indonesian government to initiate quickly a dialogue on reform with its citizens. Giving the people of Indonesia a real voice in the country's political affairs can make a real contribution to restoring political order and stability based on human rights and the rule of law."²⁷ But it is doubtful that Mr. Soeharto was following reports of foreign opinion at this point. En route home

²⁶Janadas Devan, "How US tackles the Jakarta problem, *Straits Times*, May 10, 1998.

²⁷Statement by the President, "Indonesia." The White House. Office of the Press Secretary (Birmingham, England). May 15, 1998.

from a conference in Cairo, he was soon meeting with his closest civilian and military advisers, trying to determine how far he had to go to assuage domestic opinion.

The Clinton administration was immediately under pressure from congressional Democrats to intervene directly in the Indonesian crisis by exerting pressure on Mr. Soeharto to leave office. Assistant Secretary of State Roth said on May 18 that the administration did not want to "stir the pot in a very tense situation and possibly get an outcome we don't want." The administration, he said, also would not spell out the kind of political reforms it believed should take place in Indonesia. "We have specifically avoided doing that...these are things the Indonesians have to work out."²⁸ Mr. Soeharto on May 19 proposed fresh elections, but failed to name a date, and was seen in Jakarta as stalling yet again. Madeleine Albright in a speech on May 20 said of Mr. Soeharto: "Now he has the opportunity for an historic act of statesmanship -- one that will preserve his legacy as a man who not only led his country, but who provided for its democratic transition."²⁹ This statement was widely seen as a call for Mr. Soeharto to give way and step down. By this time, however, the die was already cast in Jakarta, and Mr. Soeharto was preparing to resign.

The United States was undoubtedly right to have delayed expressing an opinion about Mr. Soeharto's tenure in office. It was important for the Indonesians to manage their political crisis with a minimum of outside involvement. And it was prudent for the United States to retain its own freedom from premature identification with competing Indonesian interests. What was to follow Mr. Soeharto was not known. It was highly improbable that common sense should have prevailed as thoroughly as it did in Jakarta in May 1998 -- a tribute to the practical wisdom of a large swath of the national elite. The violence might well have been much more extensive. It might have left civilians and the armed forces pitted angrily against each other. It might even have resulted in a military junta in control. That it led to a continuing and widening process of jockeying for power was hardly the most likely outcome.

In regard to economic policy, however, the United States and the IMF had some reevaluating to do. The Treasury view that economic stability would contribute to political stability was turned on its head by the events in Indonesia; they demonstrated instead that political change was essential to economic stability. What began as a reasonable risk, that the Soeharto

²⁸Alan Elsner, Reuters, "U.S. resists pressure to call for Suharto to go," reuters@clari.net, May 18, 1997.

²⁹Secretary of State Madeleine K. Albright, Commencement Address to the United States Coast Guard Academy, New London, Connecticut, May 20, 1998. As released by the Office of the Spokesman, U.S. Department of State. As delivered.

government could work its way out of the crisis with IMF help, had become increasingly doubtful as the months passed. The Indonesian president, who had taken hard decisions when faced with the necessity of doing so on many occasions over the previous three decades, proved unable to do so in 1998. In the end, the IMF was unable to extricate itself from the quagmire. In the circumstances, it did the only reasonable thing left to it. The IMF starved the Soeharto regime of cash.

The Indonesian crisis was still worsening as this was written in June 1998. The Habibie government was under continuing pressure to speed up the calling of new parliamentary and presidential elections. Mr. Habibie also was under pressure to speed the investigation of the assets of Mr. Soeharto and his family and friends. Meanwhile the currency was trading at around Rp.15,000 to the dollar. Gross domestic product was now expected to shrink by 10 to 20 percent in 1998. Inflation was climbing toward an annual rate of 100 percent, and unemployment toward 20 million. As the IMF readied itself to resume pay-outs to Indonesia, it was announced that the \$43 billion initially mobilized for the Indonesia bailout would not be enough, that another \$6 billion would be needed.

The IMF record in Indonesia left much to be desired on the institutional elements of its program as well. The foreign banks reached a settlement on June 4 that provided for a three-year suspension of payments of principal on perhaps as much as \$60 billion in the debt of private Indonesian corporations, but many doubted the agreement would work so long as the currency continued to fall in value. There still was no strategy for resolution of the banking system, and many wondered whether any private banks would survive. The public budget was now expected to be in deficit to the extent of six percent or more of GDP. In defense of the IMF, these failures were inextricably linked to the lack of confidence in the Soeharto and Habibie governments. If Indonesian politics soon brought to authority a government with a broad base of public support, the IMF would enter a new chapter in its relations with that country, and in time a more positive judgment might be possible. For the present, the evidence favored the critics. The IMF had gotten off on the wrong foot in Indonesia, and it never recovered sufficiently to get ahead of events there. The IMF was flexible and pragmatic; it did not hesitate to change its position as events dictated. But it failed to get an authoritative grip on the situation because the changing cabinets of Indonesia were unable to do so.

Larger Questions

As important as the IMF remedies were to a resolution of the Asian monetary crisis, public debate in the United States was not concerned primarily with the efficacy of the IMF programs imposed on the several countries. Serious discussion as to whether the IMF had been right in raising interest rates and trying to hold down budget deficits was limited to professional economists. The questions that engaged policy makers in Washington were larger ones.

The debate might be said to have begun on January 21, 1998, when Treasury Secretary Rubin defended the Clinton Administration's efforts to calm the financial turmoil in Asia in a major address at Georgetown University. By this time Korea had joined Thailand and Indonesia in turning to the IMF for help. The heart of Mr. Rubin's argument was that, while the effects of the crisis on the United States had been relatively limited so far, the financial instability could spread to additional nations and eventually derail the long economic expansion and stock market

boom enjoyed by many Americans. "When we act to resolve the Asia crisis," he said, "we act to protect and benefit the American people."³⁰

Alan Greenspan, chairman of the Federal Reserve, supported Mr. Rubin on the central point of his argument. Mr. Greenspan told a Senate committee a week after Mr. Rubin's speech that the Asian crisis would soon be felt in the United States. "We have as yet experienced only the peripheral winds of the Asian crisis," he said. But before spring is over, the fall of currency values in Asia "will be showing through here in reductions in demand for our exports and intensified competition from imports. All of this suggests that the growth of economic activity in this country will moderate from the recent brisk pace."³¹ While such a slowdown "would appear helpful at this juncture," there was a gloomier possibility on the horizon. As Mr. Greenspan said a day later in testimony before a committee of the House, growth in the United States might slow too much if the Asia crisis spread. Mr. Greenspan said there was "a small but not negligible probability that the upset in East Asia could have unexpectedly negative effects on Japan, Latin America and Eastern and Central Europe that in turn could have repercussions elsewhere, including the United States."³²

For the first months of the Indonesian crisis, the U.S. stock market was booming as though the crisis would have no negative impact on the United States at all. The Dow Jones industrial average closed at a record 8,545 on February 27, 1998, the first time the Dow ever

³⁰Richard W. Stevenson, "Rubin Defends Asian Bailout and Asks Funds for IMF," *The New York Times*, January 22, 1998.

³¹Richard W. Stevenson, "Fed Chief Sees Benefit to U.S. in Asia Crisis: A Slowdown in Spring Would Block Inflation," *The New York Times*, January 29, 1998.

³²Richard W. Stevenson, "Inflation Whimpers. What's Next for Fed? New Stresses at Home and Abroad," *The New York Times*, January 29, 1998.

closed above the 8,500 mark. In early April, the Dow closed for the first time above 9,000. But the Dow did not continue to rise. It closed below 8,900 on April 26 and again on May 29, and below 9,000 as late as June 30, amid growing concerns that turmoil in Asia could damage U.S. corporate profits.

At the same time, there were signs in Commerce Department reports that problems were appearing in the U.S. economy and that Asia's problems were part of the cause. In late March the Commerce Department reported that the trade deficit soared in January 1998 to its highest level in a decade as the financial crisis in Asia depressed demand for American goods.³³ At the end of

March the Commerce Department also reported a drop in corporate profits in the fourth quarter of 1997.³⁴

By June, the Japanese economy was in recession, Russia was appealing for increased IMF help, the Hong Kong economy was in trouble, labor problems were arising in Korea, and markets were down in Germany, Brazil and Mexico.³⁵ But it was not yet possible to confirm the wisdom of Mr. Rubin's decision to intervene in the crisis on the basis of hard U.S. economic data. On June 10, Alan Greenspan said the U.S. economy was "enjoying a virtuous cycle," in which rising stock prices encouraged spending and growth, and he raised the possibility that the economy had "moved beyond history."³⁶ In the environment created by such official comments, the Congress was under no pressure to act favorably on IMF funding.

The lack of pressure on the American economy also provided time for critics to come to the fore. Among the first were three prominent free-market proponents who argued that the IMF

³³Richard W. Stevenson, "January Trade Deficit Soared, as the Asia Crisis Hit Home," *The New York Times*, March 20, 1998.

³⁴Bloomberg News, "Corporations' Profits Fell in 4th Quarter: Asian Crisis Is Slowed; Economic Rise Slows," *New York Times*, March 27, 1998.

³⁵Timothy L. O'Brien, "A Frenzy of Global Anxiety Kicks Up Dust That Had Been Settling," *The New York Times*, May 28, 1998; and Bloomberg News, "Market Falls Again, Ending Worst Month Since October," *The New York Times*, May 30, 1998.

³⁶Mitchell Martin, "Greenspan Says U.S. Is in a 'Virtuous Cycle': Economy Weathers The Asian Threat," *International Herald Tribune*, Singapore, June 11, 1998.

was actually inviting more bailouts by protecting improvident lenders and borrowers from the full cost of their own bad judgment. George P. Shultz, William E. Simon and Walter B. Wriston said in an article in *The Wall Street Journal* in early February that it was "the IMF's promise of massive intervention that has spurred a global meltdown of financial markets." What should have been done in the first place was to "let the private parties most involved share the pain and resolve their differences." It was urgent that the IMF be stopped. Otherwise, "further bailouts, unprecedented in scope, will follow."³⁷ This confidence in the ability of the financial markets to sort themselves out was shared by at least a small minority in the Congress, including some key figures in the House, among them Representative Dick Armey of Texas, the majority leader. However, anyone familiar with the damage that the financial markets had helped to create in Indonesia, and their inability to make rapid progress in recovering from the damage, could be excused for not sharing the confidence of Mr. Shultz and his associates.

A narrower conservative position was that the IMF was right to intervene in the Asian cases, but wrong to impose structural and institutional reforms. In an article in *Foreign Affairs*, Martin Feldstein, a Harvard professor of economics and a former chairman of the Council of Economic Advisers, charged that the IMF was "overdoing it" in East Asia. By imposing reforms, as opposed to focusing on balance-of-payments adjustments, the IMF would cause governments in future to fail to turn to the Fund in a timely manner.³⁸ It was correct to observe that an end to the private monopolies and cartels would have no direct effect on restarting the flow of international capital into the Indonesian economy. However, there was good reason for ending them. Their disbandment was widely viewed in the market as a test of whether Mr. Soeharto was able and willing to make the hard decisions that were needed to stabilize the economy. Moreover, as a practical political matter, it is unlikely that any American government would have put \$3 billion at risk in Indonesia without assurances of substantial reductions in the preferential arrangements enjoyed by the Soeharto family and its friends. This was to demand no more than responsible management of borrowed taxpayer money. Also, the U.S. interest in structural reforms to improve the quality of governance was not new. They were a part of World Bank programs for some years. What was relatively new was the imposition of such reforms by the IMF, which meant their application in the midst of a crisis when the leverage of the international community was at its peak. But if not then, when?

³⁷George P. Shultz, William E. Simon and Walter B. Wriston, "Who Needs the IMF?", *The Wall Street Journal: Interactive Edition*, February 3, 1998. For a more extensive treatment of their argument, see the statement by Charles W. Calomiris of the Columbia Business School before the Joint Economic Committee of the Congress, February 24, 1998.

³⁸Martin Feldstein, "Refocusing the IMF," *Foreign Affairs*, March/April 1998, pp. 23-24.

Liberal critics took the opposite tack: that the IMF should make it a condition for help to the Indonesian economy that the government there improve political, religious and worker rights, and conditions in East Timor. In a letter of April 2 to President Clinton, a group of 27 members of Congress demanding these conditions threatened to oppose increased American funding of the IMF. The group included David Bonior, the second-ranking Democrat in the House of Representatives.³⁹ But these critics ignored the fact that the IMF already was making substantial political demands on the Soeharto government. Making the demands this group proposed might have ended all possible IMF influence in Jakarta.

Democratic critics also found fault with the IMF proposal to amend its charter to allow the Fund, when studying a country's economy, to examine its openness to all types of investment. The proposal was seen as a means of promoting the unrestricted movement of capital in and out of countries. The House Democratic leader, Richard A. Gephardt, and five senior colleagues threatened to withdraw support for President Clinton's request for new financing for the IMF out of concern that the charter proposal failed to attend to the need to mitigate the human consequences of financial globalization.⁴⁰ Here the critics could indeed cite the Indonesian case as an example. Indonesia was wide open to capital flows in and out of its economy. Indeed, one would have thought that was part of its problem.

Still other critics took the view that the United States should seek nothing less than Mr. Soeharto's removal from the Indonesian presidency. This view was put forward by activists in Indonesia, by such publications as *The New York Times* and *The Economist*, and by Newt Gingrich, the Republican Speaker of the House of Representatives. In an interview, Mr. Gingrich said: "In Indonesia there have to be clear negotiated mileposts for each tranche. Unless there are serious, step-by-step, measurable, visible signs of change we are not going to help you because an unreformed, corrupt Indonesian government is going to absorb all the money we send and still not solve the problem." Advised by his interviewer that the matter was complicated by "the uncertainty of succession, like President Suharto stepping down," Mr. Gingrich replied: "Maybe that should be our goal."⁴¹

Should the United States have tried to bring President Soeharto down? Could it have done so? Had the United States halted the IMF program with the selection of Mr. Habibie as the

³⁹Adam Entous, "U.S. lawmakers seek crackdown on Indonesia," Reuters, reuters@clari.net, April 2, 1998.

⁴⁰Eric Schmitt, "Democrats Threaten to Oppose IMF Bill," *The New York Times*, May 2, 1998.

⁴¹Interview by Editor Nayan Chanda, "Strings Attached," *Far Eastern Economic Review*, February 25, 1998.

successor to Mr. Soeharto, the army of Indonesia would not have withdrawn its support of Mr. Soeharto. If protests mounted in size, those who knew the Indonesian army well thought that its leaders would order their troops to fire on unarmed civilians in the streets, and that their troops would fire. Doubt arose only in the event of crowds that were overwhelming in size; that might move the army to tell Mr. Soeharto to step down. While this is in fact what eventually occurred as a result of the fuel price rise, the student killings, and three days of mob rule in Jakarta, it would have been irresponsible for the United States to have tried to precipitate such a situation. Moreover, in the leaderless movement that was developing in Indonesia, uncertainty about who would succeed Mr. Soeharto continued right up to Mr. Soeharto's resignation, and still does as this is written. The resignation occurred several months sooner than the political opposition in Jakarta expected, and time was too short for support to coalesce around a candidate. In these circumstances, the United States could not have either removed Mr. Soeharto or put in place a successor.

The United States could have taken a less cautious stance toward Mr. Soeharto than it did, however. In early February 1998, Paul Wolfowitz, who served as assistant secretary of state for East Asian and Pacific affairs, ambassador to Indonesia and undersecretary of defense for policy in the Reagan and Bush administrations, argued in an article in *The Wall Street Journal* that Mr. Soeharto "must widen the base of his government by reaching out to critics and disaffected elements."⁴² Had the United States seriously pursued this line of thinking with the Indonesian president, it might have helped avoid the trauma that occurred. But no one in the Administration had Mr. Wolfowitz's first-hand experience or the confidence that flowed from it.

With this last exception, and the issue of unhindered capital flows, the Indonesian case did not support any different course of action than that taken by the IMF and the United States. The critics did, however, reflect the wide array of opinion in the face of the Asian crisis. And the combination of the attacks on the U.S. administration and the IMF from the right and the left achieved several results. They contributed to a situation in the House of Representatives in which support for IMF replenishment was insufficient to match the approval that had already passed the Senate. The criticisms also narrowed the freedom of action of the U.S. administration and the IMF by placing them on the defensive, a position from which it was difficult for either to change course. In addition, the attacks contributed to the atmosphere of frustration with which the United States and the IMF dealt with the Soeharto government in its final stages, limiting their ability to look beyond it.

On the whole, it was not an edifying example of U.S. foreign policy development, even without taking into account the intrusion of the extraneous issue of abortion. The conclusion

⁴²Paul Wolfowitz, "Indonesia's Challenge," *The Wall Street Journal*, February 5, 1998.

that the U.S. administration itself was in some disarray in regard to policy in the Asian crisis was hard to avoid.

Future U.S. Policy

The fall of Soeharto in May 1998 opened a new and challenging chapter for U.S. policy with regard to Indonesia. The United States has a strategic interest in Indonesia. It has an interest in an Indonesia that is a stabilizing geopolitical element in Southeast Asia and in the wider region of East Asia and the Pacific, rather than, as at present, a destabilizing one. It has an interest in an Indonesia that is a positive element in the recovery of the East Asian economies, rather than, as at present, a drag on its neighbors. And it has an interest in an Indonesia that comes out of its transition from authoritarianism with a government that has a broad base of support and is accountable for its actions.

None of these Indonesias was assured as this was written at the end of June 1998. The cohesion of the nation state was threatened for the first time since the 1950s, as autonomy was proposed for East Timor, and leaders elsewhere in eastern Indonesia talked of autonomy for themselves. Meanwhile, in the capital, the elite was just beginning to refashion its political ideas and institutions. And the economy continued its head-long rush toward disaster.

It was estimated that 40 million people were vulnerable to food shortages as a result of dwindling purchasing power, the high inflation rate, the low rupiah exchange rate, and loss of employment. If the economy continued to decline at its current pace, it was feared, further rioting might well break out before the end of the year, and martial law declared to maintain law and order. Indonesia needed humanitarian and economic aid on a large scale. With generous international support, some intellectuals believed elections could be held in six months to a year, making Indonesia the world's third largest democracy. This was not a certainty, perhaps not even a high probability, but it was possible. So the stakes were high.

What role should the United States play in the restructuring of Indonesia's political and economic life? How fully should it try to influence the significant political decisions that would be taken as Indonesia attempts a fundamental restructuring of its political system, perhaps leading to a more democratic government that might at the same time be more nationalist and Islamist in its orientation? How fully should it try to lead the international community to mobilize the resources needed to stem the downward spiraling of the Indonesian economy, threatening the loss of lives from shortages of food and jobs, and threatening the civil order with a renewal of mass violence?

The United States needed to formulate a coherent policy on Indonesia, and not rely on the ad hoc reaction to events that had marked its behavior through the first half of 1998. The White House had to coordinate American policy more actively than it had done previously; allowing the

Treasury, the State Department, and the Pentagon to pursue their separate agendas had sown confusion about U.S. priorities and intentions.

A coherent U.S. policy on Indonesia would begin with the U.S. interest in alleviating the worst suffering from the economic collapse. The shortage of food was fundamental; the country needed to import more food than it could any longer afford to buy, and unemployed people needed money to buy food they could no longer pay for at market prices. That food riots had not yet occurred by the end of June 1998 was something of a surprise to analysts, and a tribute to the persistence and effective functioning of the extended family as a social system. But the prospect of millions of poor people suffering from a monetary crisis that had its origins outside the country as well as within it called for a larger U.S. response. Much of the world looks to the United States to set the standard for humanitarian action, and the first offers of official U.S. help, on the order of \$100 million, were, in relation to the immensity of the need, modest to say the least. The United States should make it a matter of policy to provide leadership to the international community's response to the need for humanitarian action in Indonesia, including the generous provision of help usually expected by the leader of any fund-raising effort. And this leadership should be provided irrespective of judgments about the legitimacy or effectiveness of the sitting Indonesian government.

The harder question was what economic assistance the United States should make available to Indonesia, directly and through international financial institutions, so long as Mr. Habibie was president of Indonesia. The assumption of domestic critics of Mr. Habibie was that international economic aid to Indonesia, so long as he occupied the office of president, would redound to his credit and strengthen his claim to the office. Some were therefore opposed to any foreign economic aid to the Indonesian government. In deference to this view, the World Bank designed a "social safety net" program of aid to poor families that would be operated exclusively through non-governmental organizations and presided over by a national council of notable citizens. Some critics of Mr. Habibie agreed that economic assistance in the forms of export credits and small business operating capital was acceptable on the ground that it would help provide urgently needed employment.

More difficult was the question of what the United States and the international financial institutions should do in the way of budget support to help the Habibie government maintain existing public services in the absence of adequate tax revenue to pay for them. While this sort of foreign aid was fiercely opposed by some in the opposition, moderates took the view that the economic crisis was cutting too deeply to permit political partisanship to determine what was and was not done. These opponents of Mr. Habibie also took account of the prospect that any lessening in the severity of the economic crisis would give the government that would emerge from the electoral process a better start on the eventual task of economic recovery. These moderate views seemed eminently sensible, and the United States would be wise to adopt them as

its own.

Meanwhile the IMF made it known that the \$43 billion initially mobilized for the Indonesian bailout would not be enough -- that something on the order of \$6 billion more would be needed. Nor could anyone give credible assurance that this would be the last occasion of the kind. Yet any donor government among the industrial democracies would have to take into account the view of Indonesia as a country of widespread corruption and unearned wealth, especially among Soeharto's family and friends. It was possible that a significant portion of this wealth was already hidden outside the country. It also was likely that much of the wealth that remained in Indonesia was greatly depreciated in value. In addition, the investigation of the legitimacy of the transactions by which these assets were acquired not only would take time and money but, as the experience of the Philippines with hidden Marcos wealth had shown, might yield only limited concrete results. Nevertheless it would be unconscionable for any government of Indonesia to fail to seek maximal recovery of Soeharto assets while at the same time asking foreign governments, and in the end their taxpayers, to provide public monies to subsidize itself. The United States should be plainspoken in making a vigorous public investigation a condition of further financial commitments to Indonesia.

Foreign public aid is only a short-term answer to what troubles the Indonesian economy in any case. All the aid that can be mobilized will fall far short of replacing the private capital, domestic and foreign, that has fled Indonesia and in time must be attracted back if the economy is to recover. It seemed unlikely that the government led by Mr. Habibie would make much headway in this regard. He is seen by economists as eccentric in his economic thinking, and by private businessmen as unfriendly to the market place. Many see him as corrupt, and see his cabinet as including anti-Chinese racists. These views are so widespread among economists and businessmen interviewed by the writer in June 1998 that they constitute a major reason for the international community to make clear two expectations of Mr. Habibie: that he and the Indonesian armed forces commit themselves unequivocally to the protection of the persons and property of law-abiding citizens of Chinese descent; and that he honor his pledge to work toward national elections on a schedule and terms agreed upon with the opposition.

Chinese-Indonesians were traumatized by the rioting, looting, burning and raping to which they were subjected during the three days of May 13, 14 and 15, 1998. Some who could afford it were scattered as far as Perth on the West coast of Australia and Portland on the West coast of North America in search of counseling. Tens of thousands who fled to Singapore and other places of refuge in the region were staying put. Thousands more still in Indonesia were making plans to leave. But most Chinese-Indonesians could not leave; their future would depend on how the indigenous majority would decide to deal with them. Many indigenous Indonesians were shaken by the violence that revealed a racism they had failed to acknowledge as endemic to their society. The problem is plainly deep-seated and will require long-term attention by national

leaders. In the short term, measures were urgently required to give a sense of security to Chinese-Indonesian businessmen. Foreign investors were not likely to return to Indonesia in any number so long as local investors were holding off resuming business activity. The donor community had every reason to require continuing attention to this problem by Mr. Habibie and any subsequent president of Indonesia, as well as by the Indonesian armed forces, as a sine qua non for economic aid.

Indonesian elections would be a matter of great interest on the part of the United States, considering the priority given to political rights in foreign policy during the Clinton presidency. Mr. Habibie proposed a schedule for rewriting the relevant laws, electing a new parliament, and electing a president that would require 18 months from start to finish. This schedule was plausible, but some members of the opposition considered it much too leisurely. They said it could all be done in six months' time. Any particular timing favored particular groups, and there was no schedule that was best for all. But Mr. Habibie's legitimacy was not such as to permit him to foreclose the issue; after all, he had agreed that his ascension to the presidency was of sufficiently doubtful legitimacy as to make fresh elections desirable in the first place. But their timing, as with much else having to do with the elections, should be resolved by consultation among all the major political actors expected to play a role in the elections.

Many other issues bearing on the elections would arise before they would take place, including how they were to be financed, whether seats were to be reserved in the parliament for the armed forces, how violence was to be kept under reasonable control during the campaign, and who should oversee the election process and certify the results. The United States has had considerable experience with elections in transitions from authoritarianism around the world but would be wise to eschew a leading role here; the United States is too convenient a target for political fringe groups in Indonesia, as witness the demonstrations occurring regularly at its embassy in Jakarta and its consulate in Surabaya. At the same time, the internationalization of the Indonesian elections would be a means of helping to neutralize the darker forces that inevitably will be involved in the process. This internationalization would desirably have a major regional element, including access to the experience of the Thais, Filipinos, and Koreans. The United States could contribute to the likelihood that these elections would take place, and that they would take place under acceptable circumstances, by taking steps to create an intergovernmental contact group on the elections comparable to the intergovernmental group that worked so effectively on the currency board threat.

With Indonesia in a condition of dependency on the international community, the issue of East Timor was bound to come to the fore. Indonesia had for some time been prepared to grant autonomy to the former Portuguese colony in return for international recognition of Indonesian sovereignty there. Mr. Habibie made the offer public in June 1998, and it was welcomed by East Timorese leaders there and in exile. But the East Timorese were not prepared to concede

sovereignty, demanding a referendum in five years' time, and withdrawal of Indonesian troops in the meantime, as they appeared unable to maintain order without shooting and killing local youths. The problem the international community faced was that the situation in East Timor was not well known or understood in Indonesia itself; the elite had all along been content to accept the official view that Indonesia could not have been wrong to invade and annex this small, defenseless neighbor. Nor was it clear that independence without some form of association with Indonesia would be in the interest of East Timor, which has very limited natural and human resources. The U.S. position had been to acknowledge Indonesian control, while maintaining that a valid act of self-determination had not taken place. It would require an Indonesian government that represented a cleaner break from the past than that of Mr. Habibie to make a commitment to a valid act of self-determination. But the United States should be advising the Indonesians that such an act would be required to satisfy international opinion.

The United States also faced the need to clarify its policy with respect to the Indonesian armed forces. The Pentagon played a rear-guard role throughout the long process by which U.S. support to the Indonesian forces was reduced under Congressional pressure, cutting off sales of small arms that could be used against civilians, then watching as Indonesia, to save face, canceled the purchase of F-16 aircraft and access to U.S. military training institutions. Unknown to the Congress, the U.S. armed forces continued secret joint training exercises, principally involving the special forces of the two nations. It was not coincidental that the Indonesian special forces were led for many years by Prabowo Subianto, the Soeharto son-in-law who had significant U.S. training and was something of a darling of the Pentagon. His ambition led, however, to a major split within the Indonesian armed forces and contributed to their ineffectiveness in the rioting of mid-May 1998. Indonesia was approaching what could be a major revision of the role of the armed forces in the political life of the country. In these circumstances, it was about time the United States came to a new view of its own of the Indonesian armed forces. Joint programs of every kind should be suspended pending satisfactory completion of investigations of alleged abuses. Resumption of joint programs should be calibrated to the degree to which the Indonesian forces accept the demilitarization of Indonesian political life. This might be some time in coming, but delay would principally be a matter for the Indonesian armed forces themselves to decide.

The United States should be prepared for the possibility of large-scale violence in Indonesia. Should this occur, the United States should be ready to make an independent assessment of the need for martial law and ready for the possibility that the armed forces of Indonesia may be unable to control the situation. The judgment of neither the caretaker Habibie government nor the armed forces leadership can be accepted at face value in regard to the need for martial law. Both face potentially harsh judgments as the political system evolves and investigations of abuse and corruption multiply. Similarly, the possibility cannot be ruled out that an overextended armed forces could lose control and Indonesia's national cohesion could begin to weaken seriously, beginning in eastern Indonesia, which was left out of the economic boom and is

likely to feel left out of the emergency relief.

The problems of Indonesia are fundamentally political, and they can be addressed only by political means. It might be necessary to respond to emergency conditions by use of the police power in restricted locations for short periods of time. But army suppression of political activity may well have run its course as a useful tactic in Indonesia. It is time for everyone involved to think strategically. It is in the interest of regional stability that Indonesia not begin to fragment. And only a broad-based coalition of national unity seems any longer likely to assure that.

The United States is, as we have seen, markedly ill-favored to play a strategic role in regard to Indonesia. No senior person in any department of the Administration has lived and worked in Indonesia. The official U.S. presence in Indonesia is relatively small. Congress has been preoccupied elsewhere. The United States needs badly to deal with the problem of limited contact, poor intelligence, and unauthoritative analysis. It is not as though the country at large is as incapacitated as the U.S. government, however, and the government needs to devise means to draw on the knowledge and experience that lies outside its ranks.

The experience with Indonesia also demonstrates that the United States needs a new strategy to deal with the new problems resulting from the global movement of private capital. If future massive bailouts are to be avoided, the systemic problem that gave rise to the Asian crisis has to be dealt with: how to reduce the volatility of short-term capital flows in the international financial system in the first place. An economy as vulnerable as that of Indonesia needs some form of protection from massive short-term capital flight, and the United States and the IMF need to be thinking about how this is to be accomplished in the future. Improved monitoring is a necessary element of any plan for the future, as Treasury Secretary Rubin has suggested. But international monitoring can be no better than the data provided by individual governments. There is no alternative to greater financial transparency within the banking sector of national economies. The long delay in addressing the need for bank reform in Indonesia suggests how difficult that will be to achieve. So there is a need also to give more thought to constraints on the short-term movement of capital that governments may introduce for their own protection. The exuberance followed by panic displayed by money managers in the Asian crisis makes plain that the financial markets are far from perfect and cannot be relied upon exclusively.

Demanding structural reforms of the government of Indonesia was an inevitable task for the IMF if it was to design a way out of the crisis that would merit international support. It is possible that some future governments in crisis will fail to come to the IMF in a timely fashion out of fear that the political cost will be higher than it is prepared to pay. But it is not unreasonable to expect that a concern for issues of governance, which are regularly raised in connection with World Bank programs, should be made an active concern of the IMF as well. While the United

States is considering changes in the IMF charter, it should consider introducing language that would give the IMF a mandate to take issues of governance into account as a regular part of its activity.

Beyond these several fundamental positions it is in our opinion unwise for the United States to venture. The fall of Soeharto was a matter properly left to the Indonesians. The putting in place of a legitimate successor regime should be left to them as well. There are many issues that lie ahead for Indonesia that are of interest to Americans. But the United States lacks the expertise and experience in its government to attempt to stage-manage the Indonesian transition from authoritarianism. The United States can help the Indonesians most by respecting their freedom to write their political history in their own way.