Life with the IMF:
Indonesia's Choices for the Future

Jack Boorman and Andrea Richter Hume

Contents

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INDONESIA'S CHOICE FOR THE FUTURE

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INTRODUCTION

This paper discusses issues related to Indonesia's economic reform strategy as it comes to the conclusion of its current financing arrangement with the IMF. We begin with a brief consideration of the historical backdrop to Indonesia's recent economic performance. Before turning to issues related to Indonesia's exit strategy, we present in Section II some of the key conclusion to be drawn from Indonesia's experience during Asian crisis, focusing in particular areas where the IMF's policy advice has come under particular scrutiny [2]. In section III, we consider the recent performance of the Indonesian economy and highlight some of its future development challenges. In order to help frame in exit strategy debate, Section IV presents information of the types of relationship with the IMF available to Indonesia (or any member country). Some relevant observations regarding the relations of other large countries with the IMF are presented in Section V, while lessons learned from the crisis, and a few concluding thoughts, are presented in Section VI.

Historical backdrop to Indonesia's recent economic performance.

Before discussing Indonesia's more recent economic record, it is worth noting the considerable strides made in the two decades preceding the crisis. In 1975, Indonesia's GDP per capita was about US$470 (current PPP basis), similarly to many other low-income countries (Table 1). Its socioeconomic indicator were similarly depressed. By 2000, however, Indonesia's GDP per capita has risen to about US$3,040. Significant progress can also be seen in other indicators of development: the illiteracy rate fell from nearly 40 % in 1975 to 13 % in 2000; average life expectancy increased from 51 to 66 years; and infant mortality declined by two-thirds. Against virtually any historical comparison, this has been a remarkable record of socioeconomic development, which has transformed the quality of life of the average Indonesian.

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1 Special Adviser to the Managing Director and Economist, respectively, at the International Monetary Fund (Washington, D.C.). We wish to acknowledge helpful comments received on earlier draft of this paper. Any remaining errors are our own.

2 While discussion of this topic may be considered an unnecessary focus on the past, the fact that many commentators today frame their discussion of Indonesia's future relationship with the IMF by their assessment of the IMF's role in Indonesia during the Asian crisis warrants some discussion of this topic.

Table 1. Comparative Indicator of Economic Development, 1975 – 2000

GDP per Capita (US$) 1/			Life Expectancy (years) 2/		Illiteracy Rate (%) 3/	
	1975	2000	1975	2000	1975	2000
China	273	3,976	64.7	70.3	41.8	15.9
Kenya	400	1,022	52.5	47.0	51.7	17.6
Nigeria	405	896	44.4	46.8	74.1	36.1
Pakistan	415	1,928	52.3	63.0	75.7	56.8
India	461	2,358	51.8	62.8	63.1	42.8
Indonesia	**467**	**3,043**	**51.3**	**66.0**	**37.1**	**13.1**
Sri Lanka	643	3,530	66.2	73.1	17.0	8.4
Egypt	656	3,635	53.3	67.5	64.7	44.7
Ghana	793	1,964	51.2	56.9	63.6	2as
Thailand	805	6,402	60.6	68.8	15.5	4.5
Cote d'Ivoire	901	1,630	47.0	45.8	81.3	53.2
Malaysia	1,274	9,068	64.4	72.5	34.9	12.5
Philippines	1,502	3,971	59.3	69.3	13.6	4.7
South Korea	1,693	17,380	63.9	73.2	9.8	2.2
Brazil	2,304	7,625	60.8	68.1	28.2	14.8
Mexico	2,600	9,023	64.2	73.0	21.3	8.6

Source: World Development Indicators (World Bank).
1/ Annual, current PPP basis
2/ At birth.
3/ Adult populations.

Indonesia's success story was not preordained. Indeed, there are several countries that were at roughly the same stages of development as Indonesia in 1975, but have shown far less progress over the last three decades. One example is Nigeria, which as a large oil-producing economy was in many respects quite similar to Indonesia at the beginning of the 1970s. In 1975, for example, they had roughly comparable level per capita income (Indonesia's was about 15 % above that of Nigeria). However, by 2000 (and notwithstanding the Asian crisis), per capita income in Indonesia was roughly 3½ times higher than in Nigeria. Life expectancy in Indonesia, which had been only 7 years longer than in Nigeria in 1975, grew to 19 years longer in 2000.

What explains the considerable difference in performance between these otherwise similar countries? While many explanatory factors can be identified, the most important difference appears to have been the presence of macroeconomic stability in Indonesia, and the absence thereof in Nigeria [3]. Thank to a successful track record of economic and financial stability, private business and investors in Indonesia were able to plan and execute their projects with a reasonable degree of confidence in

[3] A comparison of Indonesia's economic performance with that of Nigeria was presented in a speech by Jack Boorman to the "Workshop on Macroeconomic Management", hosted by the Committee on National Planning and Economic Development, in Lagos, Nigeria in April 2002.

the macroeconomic outlook. This was supported by the implementation of sound structural policies in a number of areas (including the expansion of domestic infrastructure to support the increase the external trade and the growing oil and gas sector) that provided the necessary underpinnings for economic growth to occur. Unfortunately, this generally strong record of policy management was matched in all areas by all concomitant development of strong and transparent institutions. As governance issues and weak institutions become increasingly problematic as the economy became more sophisticated, they came to thwart the positive policy record, thus helping to create the vulnerabilities which would prove so devastating during the Asian crisis.

Cause and policy responses to the Asian crisis [4]

Despite several differences in specific aspects of the crises in Asia, weak institutions and governance problems in financial sector have been identified as a key factor in the vulnerability to crisis that developed in a number of the region's economies [5]. Inadequate regulation and supervision of the financial system has resulted in misallocation of credit, inflated asset prices, and excessive unhedged foreign borrowing by the domestic private sector. this greatly increased the vulnerability of these economies to slowdown in economic growth and a deterioration in financial asset quality. Following years of rapid growth, a deceleration in export growth beginning in 1996 put pressure on external balances and domestic economy activity. As a result, a loan portfolios deteriorated significantly, raising concerns about that weakness in financial sector would prelude the monetary authorities from raising interest rates sufficiently to defend their exchange rates; this in turn led to speculative attacks on their currencies.

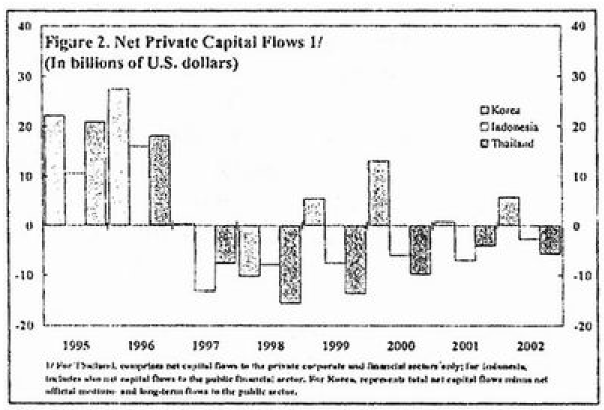

Figure 2. Net Private Capital Flows 1/
(In billions of U.S. dollars)

While the crisis economies shared similar financial vulnerabilities, their recovery paths have shown considerable differences. Korea's GDP per capita recovered fully (to its 1997 level) in 1999, only a year after the crisis (Figure 1). Recovery has been far slower in Thailand, which re-attained pre-crisis GDP per capita only in 2002, and in Indonesia, where real GDP per capita in 2002 was still about 5 % below its level in 1997. The pace

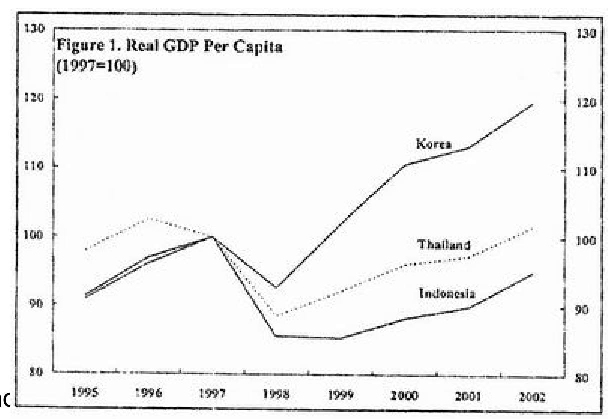

Figure 1. Real GDP Per Capita
(1997=100)

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4 The bibliography cities a selection of the better-kn
more in-depth analysis of the Asian crisis.

5 Lane et al. (1999), p. 9.

at which market confidence has returned has also differed (Figure 2). Korea was able to regain market access in April 1998 (less than four months after the nadir of the crisis), issuing a heavily over subscribed $4 billion sovereign bond. Capital flows surged in 1999 and have remained robust since then[6]. In Thailand, investor sentiment has recovered more slowly, given the considerable problems remaining in the banking and corporate sectors. This has been the case in Indonesia as well [7].

A key difference behind this record can be found in each country's policy response to crisis, the perceived commitment of their government to the adopted reform programs, and related political developments. Although Korea's initial stabilization attempt foundered in part due to a lack of commitment to the necessary monetary policy and the conflicting signals coming from the presidential candidates regarding their support for the program, a subsequent strengthening of the program by the newly elected government shored up confidence and set in motion a virtuous cycles[8]. In Thailand, policy performance was more mixed, reflecting in part ongoing political uncertainly. However, consistent implementation of macroeconomic policy, combined with a continued broadening of structural reforms by the government that came to office in November 1997, resulted in macroeconomic stabilization and a strengthening of investor confidence (as exhibited by strong FDI, which rose by roughly $1.5 billion in 1998). Indonesia's attempt to stabilize were severely undermined by the loss of control over monetary policy, uneven implementation of important structural measures (interpreted as a lack of commitment to the program), and political uncertainly in lights of concerns about the resident's health and the presidential election in March 1998. the political upheaval that followed, culminating in President Soeharto's resignation on May 21, 1998, cause the program to go off-track, casting Indonesia's into the depths of economic, financial, and political crisis.

Why did the crisis hit Indonesia so hard? In retrospect, there is no single factor that can be identified as the primary reason for the severity of the crisis. Rather, it was a confluence of factors – fundamental weaknesses in the financial sector, unhedge foreign debt of the corporate sector, institutional weaknesses and the political instability – that caused what was initially viewed as a mild case of contagion to degenerate into a full-blown crisis. Although a reasonably comprehensive economic and financial policy package was formulated in the early day of the crisis, the face that even in the face of rapidly deteriorating conditions, the authorities (in particular at the highest political level)

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6 Korea's April 1998 bond issue remains the larges-ever Asian sovereign issue. It was composed of two tranches, $1 billion due in March 2003 and $3 billion due in March 2008. The bonds were issued at a spread of 345bp and 355bp over US Treasuries, respectively.

7 Although net private capital flows to Thailand have remained negative since the crisis (due primarily to repayments of foreign credits lines by financial institutions), FDI has averaged about $3.3 billion during 1998 – 2002, higher than in the pre-crisis period, and net portfolio flows have remained positive. In contrast, although average net FDI flows to Indonesia have been roughly the same as in Thailand, they still about $5 billion per year lower than in the mid-1990s; also, net portfolio flows remained either negative or essentially zero until 2002.

8 It should be noted that Korea's usury law, which capped interest rates at 25%, initially prevented monetary policy from being tightened.

were perceived as unwilling to take the steps needed to arrest the crisis and to sustain reforms in the face of challenges from vested interest, greatly undermined the ability of the package to restore stability.

In considering the severity of the Indonesian crisis, some have place considerable blame on the policy advice given by the IMF. Indeed, there is no shortage of commentators who argue that the IMF's policy advice was not only incorrect, but in the fact exacerbated the crisis and delayed the recovery [9]. Given the importance of understanding the IMF's past role in Indonesia when considering Indonesia's strategy following the expiration of the current Fund arrangement, a brief review of the role played by the IMF in crafting the policy response to the Asian crisis is warranted.

II. IMF POLICY ADVICE TO INDONESIA DURING THE ASIAN CRISIS

The initial IMF – supported program, as set out in the October 1997 letter of intent (LOI), was designed on the assumption that the crisis was essentially a moderate case of contagion. The expectation of the Indonesian authorities was that the crisis would be over and that by implementing the agreed measures the situation could quickly be stabilized. This assessment was also generally shared by market participants [10].

In the event, emerging debates about the design of the Fund – supported program, the absence of consistent policy implementation during the early months of the crisis, and poor communication of government policies and political uncertainties, undermined public confidence and seriously handicapped the stabilization effort. Policy implementation during late 1997 was characterized by policy reversals and an uncertain degree of commitment at the highest levels of government. Efforts to control the unfolding crisis were also seriously undermined by the lack of transparency in communicating these efforts to the public. This lack of transparency did not come as a surprise, as the Soeharto government ha a little need. And therefore a little experience, in managing public expectations and integrating civil society perspectives in formulating its economic policies. However, this would prove fatal to success of the program, for as public confusion regarding the government policies grew, the loss of confidence was exacerbated. This experience, as well as that in other crisis economies with Fund-supported programs, has resulted in wide-spread recognition that a clear elaboration of the government's policy plan, including through the publication of LOIs submitted to the Fund and other documents, serves a critical role in communicating policy to the public and can serve as an important confidence-building measure in its own right [11].

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[9] See for example Stitglitz (2002) and Ramli (2002 and 2003).

[10] See for example Goldman Sachs (November 1997)

[11] The IMF at the time did not require that countries publish either the LOIs they submitted to the IMF or the staff reports prepared for consideration by the management and the Board of the IMF when

We now turn to a more detailed consideration of the specific policy advice provided by the IMF to Indonesian authorities [12]. In the area of macroeconomic policy, there is a reasonable degree of consensus that the IMF's policy recommendations were generally appropriate. On banking sector policy, however, and specifically on the question pf bank closures and the deposit guarantee, the IMF's policy advice has come under particularly heavy fire. The scope of structural conditionality has also been subjected to heavy scrutiny.

A. Macroeconomic Policy

Fiscal Policy

Although the fiscal targets agreed in the first LOI turned out to be too tight in light of the deteriorating level of activity in the economy, these were adjusted quickly as the depth of the crisis became apparent. Prior to approaching the IMF, the authorities had already responded to the evolving crisis by delaying expenditure on low-productivity projects. The program set out in October 1997 LOI proposed a modest fiscal tightening for the1998/99 fiscal year, reflecting the basic assumption (shared by the IMF and the authorities) of a relatively moderate economic slowdown, and anticipating the need for the budget to cover the carrying costs of the possible recapitalization of some segments of the banking sector [13]. By the time the third LOI was signed in April 1998, and the depth of the crisis had become apparent, the deficit target for the 1998/99 fiscal year has been raised to nearly 5%, and incorporated the need for temporary subsidies to protect the poor.

In the event, the actual budget deficit in 1998/99 was 2.3% of GDP (compared to a deficit of 1.3% of GDP in 1997/98), indicating that fiscal policy was far less expansionary than allowed under the program. This reflected in part the Ministry of Finance's fiscal conservatism – which had served the government well under different circumstances – but also the absence of institutional mechanism to increase the targeted spending increases under the social safety net. With hindsight, the IMF could have been more proactive in pushing for a looser fiscal stance from the start. Although setting tight fiscal targets initially does not appear to have done much harm to the economy (given that the targets were quickly revised upward), setting looser targets

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responding to a request by a member for financial support. Lessons learned regarding the importance of communicating the government's reform program has led to a change in IMF practices, with LOIs now expected to be published (unlike before the Asian crisis). Between January 2000 and March 2003, 93 % of all LOIs were published.

[12] We focus on policy advice provided by the IMF during 1997 and the first half of 1998.

[13] The rationale for tighter fiscal policy was that public saving could contribute to the overall current account adjustment dictated by the reversal of capital flows and by boosting confidence, could influence the total amount of adjustment required.

initially may have resulted in more expansionary fiscal policy during 1998/99, with possible positive effects on economic activity. Even ex post, however, this is a difficult issue to judge as the market reaction to an initial fiscal policy stances that may have been seen as inappropriately loose cannot be known.

Monetary policy [14]

The recommendations made by the IMF on monetary policy have proved to be more contentious, with the primary criticism being that the recommended policy was too tight and did not stem the depreciation of the rupiah. Indonesia was faced with the policy dilemma presented by a "twin crisis" that was impacting both the exchange rate and the financial sector. One the one hand, the high interest rates needed to support the exchange rate would seriously weaken corporate and bank balance sheets; on the other hand, allowing a large exchange rate depreciation would likely result in widespread corporate bankruptcy due to heavy external indebtedness, which in turn would further weaken the financial sector.

Following the abolition of the exchange rate peg in August 1997, there was a need for the monetary authorities to clearly communicate what would serve as the anchor for monetary policy [15]. Bank Indonesia's (BI's) increase the one-month SBI rate, from 10% to 30% in August 1997, suggested that interest rates would be used aggressively to protect the exchange rate, thus preserving its role as a monetary anchor. However, as liquidity problems in weak banks emerged, BI reduced interest rates from 30% to 20% (in several steps) between early September and late October, thus in effect appearing to abandon its defense of the rupiah through monetary policy [16].

Given the policy dilemma presented by Indonesia's twin crisis, there was considerable debate within the IMF and with the authorities on the best policy response to the depreciation of the rupiah. The recommendation that emerged from the debate (and was encapsulated in the first LOI) represented a compromise. The program provided for tight monetary policy in the initial period of the program in order to support the exchange rate – and to clearly signal that support, it included a base money program (with quarterly targets) that envisioned a slowing in the growth of the money supply. This strategy would be reinforced, if necessary, by foreign exchange intervention to bolster confidence and provide clear direction to the market. Such intervention would be supported by the restrictive monetary stance so as to maximize

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[14] Key references for this section include Lane et al. (1999), Lindgren et al. (1999), and Enoch et al. (2003).

[15] During the precrisis years, with reasonable rates of inflation and exchange rate stability, market participants had had little interest in the details of monetary policy. This attitude changed when the peg was abolished.

[16] The one-month SBI rate stayed at 20 percent until late January 1998, when it was raised to 22%. Although interbank rates increased during this period, this reflected a segmentation of the market and the higher risk premium attached to lending to weak banks, rather than a tightening of monetary policy.

the impact of the exchange rate, while avoiding excessive depletion of international reserves. There were no specific commitments in the LOI about how interest rates should be adjusted as needed to tighten monetary policy and counter the slide of the exchange rate [17].

In the event, monetary policy veered widely off course soon after the program was launched in early November 1997 [18]. Interest rates were reduced again, and basic monetary control was lost as the country's reserves were run down through intervention. The monetary impact of this intervention was more than offset as BI provided massive liquidity injections to weak banks. Between end-October and mid-December 1997, liquidity support rose from 3.5%, of GDP to 5% of GDP. As a result, base money grew by 14% and 32%, respectively, in the last quarter of 1977 and first quarter of 1998, accommodating dramatic currency depreciation and a surge in inflation.

Due to the expansion of liquidity in late 1997, monetary policy was actually not at all tight turning this period, despite relatively high nominal interest rates (especially in the interbank market). Monetary policy was not tightened effectively until March 1998, when BI launched a comprehensive redesign of its liquidity support facilities and began to raise interest rates. Following this tightening, the exchange rate (which had peaked at Rp 13,600 in late January) steadily appreciated from Rp. 9,750 in mid-March to Rp. 7,500 by mid-April, and remained below Rp. 8,000 until the political turmoil of May 1998 [19].

Could other policy measures, for examples capital controls, have arrested the rapid depreciation of the rupiah? This measure was evaluated by the IMF in the early days following the floating of the rupiah. However, it was deemed unlikely to work, given the absence in Indonesia of the necessary infrastructure to administer such controls. Moreover, in the absence of administrative capacity, the system may well have been subject to significant corruption. (In fact capital controls had been eliminated in Indonesia in 1971 due to the difficulty of making them effective). With regard to Malaysia's experience with capital controls, it should be noted that they were not introduced until relatively late in crisis (September 1998), after the ringgit and the other currencies in the region had begun to appreciate. While capital controls do not appear to have had a significant deleterious impact on private capital flows to Malaysia, ex post it would appear that, given Malaysia's strong economic fundamentals and the return of confidence to the region shortly after the introduction of the controls, capital controls were probably not needed to defend the exchange rate peg. This suggests that Malaysia may have been able to maintain a more accommodative monetary policy, and hence experience faster economic recovery, in the absence of capital controls [20].

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[17] The authorities also committed in the LOI to collaborate closely with IMF staff on the intervention strategy, including by providing data on daily intervention in the spot and forward markets.

[18] Boorman et al. (2000), p. 32.

[19] The rupiah hits its low of Rp. 15,250 per U.S. dollar on June 17, 1998.

[20] See N. Tamarisa (2001) for a detailed analysis of Malaysia's capital controls.

B. BANKING SECTOR POLICY

In assessing the adequacy of the IMF's advice on banking sector policy, it is important to appreciate the conditions of Indonesia's banks at the start of the crisis. As documented by Pangestu and Habis (2002), Indonesian banks were not in the good position to absorb even the relatively modest initial shock that came from the depreciation of the rupiah and higher interest rates. They identify three key sources of vulnerability [21]. First, after comprehensive deregulation launched in 1988. a rapid expansion of the banking sector took place without the necessary strengthening of prudential regulations and central bank supervison. Second, the high concentration of ownership in the banking sector had led to weak corporate governance in bank. Third, the economic boom and increased international intergration in the 1980's amplified the structural vulnerability of Indonesia's financial system [22].

International audits of Indonesia's banks undertaken later in the crisis confirmed that the banking crisis in Indonesia reflected deep underlying factors [23]. The extent of delinquent loans, together with the high level of connected lending in many of the private banks, illustrated the degree to which in the pre-crisis period the state banks had been used as vehicles for directed lending to noncommercial ventures, and private banks as vehicles for channeling deposits to the owners. The audits also revealed a poor record of regulatory enforcement in the pre-crisis period, apparently due either to political interference or the lack of a proactive supervisory program. Any enforcement undertaken tended to focus on the application of fines rather than measures aimed at restoring the bank to safe and sound operating conditions. These patterns could remain largely hidden so long as the economy was growing at a fast pace; once growth reserved, the true situation became apparent.

Crafting a banking sector rescue package was complicated by the absence of timely and reliable banking data. The selected reference date for all data (provided by BI) was June 1997, as this ensured the complete availability of all necessary information, together with a range of half-yearly reports and financial statements. However, these data presented several major problems. First, June 1997 was not the right point in time for making solvency assessment, given to the exchange rate depreciation that had occurred since then. Second, the available data were not sufficient to undertake the necessary stress tests to assess the resilience of the banking system to potential change in the exchange rate. Third, supervisory information from BI

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21 Pangestu and Habis (2002), p. 4.

22 Beginning in the mid-1980s, as the Indonesian economy began to diversity away from a dependence on oil exports, foreign capital was attracted to new higher-growth sectors. Given the openness of Indonesia's capital account, this resulted in a significant increase in foreign debt financing. However, because of much this borrowing was unhedged, the Indonesian financial sector (and corporations) became heavily exposed to currency risk.

23 Enoch et al. (2001), p. 17 and p. 64.

was flawed by the low level of supervisory skills and, according to some observes, suspicious of corruption [24].

The banking rescue strategy was also fundamentally undermined by weakness in the institutions charged with implementing the strategy. Even in the best of worlds, with sound regulatory and supervisory institutions, financial crises are difficult to manage, and usually end up being very costly [25]. In the case of Indonesia, the lack of institutional integrity presented a practically insurmountable challenge to the bank rescue strategy, as there was little confidence that it would be implemented in a sound and equitable manner. (This was particularly the case in the provision of liquidity credits, as discussed below). When it became publicly perceived that the political structure was not committed to the program, it became virtually impossible to sustain the public's confidence in the government's ability to resolve the crisis. We turn now to an assessment of the three most controversial elements of the bank rescue strategy: (i) the closure of 16 small banks in November 1997; (ii) the introduction the partial deposit guarantee; and (iii) the extension of the bank liquidity support.

Closure of 16 banks

A key element of the bank rescue strategy presented in the first LOI was the closure of 16 small insolvent banks in November 1, 1997. A comprehensive assessment of Indonesia's banking sector, undertaken by BI in October 1997 with the assistance of the World Bank, the Asian Development Bank and the IMF, had concluded that 26 private banks and 8 public banks were insolvent [26]. Of the private insolvent banks, 10 had already previously entered into legally-binding "nursing" agreements with BI, meaning that they could not be closed immediately. The closure of the16 remaining insolvent banks (with a market share of 2.5 %), which included several politically well-connected banks, was initially favorably received by the public, as it was viewed as showing the authorities, commitment to addressing solvency problems in the banking system.

However, the public's confidence in the government's bank rescue strategy was quickly undermined by policy reversals and a lack of transparency. First, the owner of one of the closed banks (a son of president Suharto) was effectively allowed to reopen his bank under another name, thereby raising questions about government's commitment to stemming problems in the banking sector, perhaps, to governance problems more generally. Second, the public suspected (correctly) that there were other insolvent banks in the system, and worried that they might collapse or be closed. The fact that BI did not want to inform the public that the 10 other insolvent banks were

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24 As a noted by Cole and Slade (1996), "some of the privately-owned institutions relied on strong political backing to circumvent regulations and serve special interests", p. 6.

25 The U.S. savings and loan crisis during the 1980s, whose cost to U.S. taxpayers amounted to roughly \$124 billion (2.8 % of 1986 GDP), presents a relevant example (Curry and Shibut (2000), p.8).

26 Specific strengthening measures for the eight public banks (two state-owned and six regional development banks) were agreed as part of the Fund-supported program.

already engaged in process of resolution further fueled speculation of growing banking sector problems.

While closing the 16 insolvent banks was an appropriate measure, it should have been accompanied by a more effective communication of the overall bank rescue strategy to the public, so as to shore up depositor confidence. With hindsight, one can argue that given the weak condition of the banking system in late 1997, the other insolvent banks should have been closed at this time as well. However, even if the more systemic nature of the banking sector problems had been understood earlier, it is not clear that the government would have agreed to a greater number of (large) bank closures, given their aversion to closing banks in the first place.

Deposit guarantee

The issue of whether a blanket guarantee should have been introduced earlier has been one of the most contentious policy issues related to the overall banking sector strategy. After careful consideration in late 1997, the authorities and the IMF agreed that a blanket guarantee would not be desirable on grounds of both fiscal cost (emphasized by the authorities) and moral hazard (emphasized by the IMF). With the benefit of hindsight, one could argue that introducing the blanket guarantee sooner might have helped stabilize the situation. However, the extent of the banking sector's problem was not apparent at the time; nor was the lack of commitment of the Suharto government to addressing this problems, which later contributed to a loss of confidence in the banking system and, more broadly, in the crisis management strategy. In this connection, the concept of a partial guarantee was appropriate for a situation in which well-connected banking insiders had been benefiting both from high deposit rates and from questionable lending practices.

A key failure of the bank rescue strategy was that the rules of the partial deposit guarantee were not clearly communicated to the public. Confusion regarding key aspects of the guarantee (including which accounts would be covered, to what limit, and whether it applied to a small and large depositors) diminished the ability of the guarantee to calm depositor concerns. Although communication of the rules of the deposit guarantee was the responsibility of BI, in retrospect the IMF could have argued more forcefully for an effective communications strategy (although this may have been considered excessive intervention by the IMF into the government's communications practices).

Bank liquidity support (BLBI) [27]

The monetary policy strategy originally agreed with the IMF in October 1997 LOI, which entailed a tight money program, precluded the provision of large-scale liquidity support. In the event, given that the government opposed any further bank

[27] We refer here to the various lines of credit provided to weak banks during the crisis, which are collectively referred to as "BLBI".

closures even as the situation degenerated into a systemic banking crisis, it became apparent that some degree of liquidity expansion would be needed to keep the banking system from collapse. However, the IMF urged that, as agreed in the program, liquidity support should only be offered at market rates and against collateral, and that additional banks should be closed if necessary. In addition, interest rates should be raised to counter the expansionary effects of the liquidity injections.

Contrary to the IMF's advice, the authorities not only massively increased liquidity support to banks, but also provided this support at below-market rates and on an unsecured basis. After the bank closures in early November, liquidity support escalated rapidly.[28] Although penalty interest rates were originally imposed on this lending, the rapid increase in balances due from banks caused BI to abandon this practice. Also, in the face of difficulties in valuing the collateral offered by bank owners, BLBI eventually was offered on an unsecured basis (although owners were required to provide personal guarantees).

Subsequent investigations revealed significant misuse by banks of the liquidity support.[29] Due to the speed at which conditions in the banking sector were deteriorating (and thus the pace at which liquidity was being provided), and the absence of critical bank, data needed to assess how much liquidity support each bank was entitled to receive, the IMF was not privy to irregularities in the support operations undertaken during November and December 1997, when monetary control was lost. Governance problems only came to the fore early in 1998. If these problems had been identified sooner, it is likely that the IMF would have more strongly encouraged the authorities to set firm guidelines for the provision of liquidity (in effect pushing the IMF's original policy advice even harder). This may also have forced an earlier consideration of a blanket deposit guarantee.

C. Structural Conditionality

There has also been considerable criticism of the number and breadth of structural measures included in Indonesia's Fund-supported programs. It has been argued that the focus on structural issues undermined rather than strengthened market confidence because it reinforced the perception that the crisis had been brought on by fundamental weaknesses in the economy.[30] However, this view ignores the fact that structural problems had been identified long before the crisis.[31] Notwithstanding steps to liberalize Indonesia's economy over the previous decade, at the time of the

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28 By mid – 1998, total liquidity support reached RP 140 trillion, or 37 percent of 1998 GDP

29 The total amount of misused liquidity support was roughly Rp 82 trillion. The government subsequently negotiated "shareholder settlement agreements" with former bank owners, which provided a legal basis for repayment of the misused support. As is well known, recoveries under these agreements have been disappointing, although the government has stepped up its efforts significantly since early last year to increase recoveries.

30 See, for example, Feldstein (1998).

31 Lane et al. (1999). p. 74.

crisis there remained considerable limits on competition: in addition to barriers to foreign trade and investment, extensive domestic regulation restricted competition and supported monopolies or cartels in important sectors. A number of these restrictions were compounded by governance problems related to the weak and ineffective nature of regulatory and supervisory agencies (especially in the financial sector), which added to perceptions of inequity and uncertainty for investors.

Contrary to popular perception, almost all structural measures included in the first LOI were general in nature and were meant to be implemented over the course of the program, thus giving the government the necessary leverage to pursue the reforms, but the discretion to advance them at the pace deemed most appropriate. However, since the LOI was not published at the time and there was little detailed explanation of the program, there was considerable speculation by the public regarding the quantity and range of the structural measures.[32]

The inability of the first program to stem the crisis, combined with a lack of progress in advancing structural reforms, led to an increased focus in this area in the January 1998 LOI. Many had come to believe that more precisely defined structural conditionality was needed to restore confidence by signaling a clear break with the past. As a result, a more specific and time-bound approach to structural conditionality was presented in this (second) LOI. Once again, President Suharto did not openly oppose the expansion of structural conditionality and the inclusion of specific measures, and, in fact, signed the LOI only after being taken through its content and implications. However, it soon became clear that he was not fully committed to the program, and that vested interests close to the President were subverting the structural reform measures to which the government had committed itself.

In the end, a number of the structural measures were popular with the public and did have beneficial effects on the economy when they were implemented. One such example is the deregulation of agriculture introduced in January 1998, which sought to eliminate distorting local monopolies, monopsonies, trade restrictions, and other barriers that effectively lowered farmgate prices. (Many of these distortions had originally been introduced to benefit the well-connected elites.) Following deregulation, farmers were able to retain a higher percentage of the market price of agricultural crops, thus helping to reduce the impact of the crisis on the poor.[33]

D. Nature of the IMF-Indonesia Relationship During the Crisis

In addition to criticism leveled at the merits of the IMF's policy advice, the manner in which the IMF interacted with the Indonesian government during the crisis has also been questioned. A conventional notion in this regard is that the IMP dictated policy to the Indonesian government. However, careful assessment of the record suggests that at least at the outset, there was significant agreement between the IMF

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32 The October 1997 LOI is now publicly available on the IMF's webpage.

33 Montgomery et al. (2002).

and the authorities on how best to address the crisis. In the area of macroeconomic policy, for example, the measures adopted by the Indonesian government before the Fund-supported program was launched – tightening the money supply, putting large government projects on hold, and floating the rupiah – suggest that the IMF and the government thought alike with regard to the initial diagnosis of the crisis and the appropriate policy response.[34]

Another common characterization of the IMF is that its policy advice was cast in stone at the outset of the Fund-supported program. However, the IMF responded to the swiftly changing situation in Indonesia by adjusting its policy advice. An example of this is the fiscal policy stance for 1998/99. As discussed above, as the economic crisis deepened and it became clear that output would contract, the fiscal deficit target was progressively loosened. Similarly in the corporate sector, once its external debt problems were fully appreciated, the program was expanded to include several debt restructuring efforts, notably the Indonesia Debt Restructuring Agency (INDRA) and the Jakarta Initiative Task Force (JITF).[35]

The ability of the IMF to enforce its policy view was in any case clearly limited by the lack of commitment to the program at the highest level of the Indonesian government. As noted by an Indonesian official involved in managing the crisis, while the implementation of the program continued technically, there was clearly no "singleness of purpose." The cue from the top that alternative policies were being considered tended to diffuse implementation capacity below, thus resulting in rapidly weakening ownership of the program.

Monetary policy presents one of the clearest examples of the absence of "singleness of purpose." In early 1998, President Suharto and some of his advisors saw merit in the introduction of a currency board regime. Although the proposal was seriously evaluated by the IMF, it was opposed on the grounds that a currency board, which prevents the central bank from acting as a lender of last resort, was inconsistent with the blanket deposit guarantee that had helped stabilize the financial system. Given the fragility of the economy, a currency board at the level reportedly being considered by the authorities would not have been credible, as it would have entailed extremely high interest rates. Moreover, it would have benefited only those (well-connected) individuals who could have converted their rupiah into hard currency before foreign reserves were fully depleted.[36] With this debate carried out in full public view, it caused considerable confusion and once again weakened the ability of monetary policy to stabilize the exchange rate.

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[34] Boediono (2002), pp. 385-386.

[35] INDRA, which was set up to provide foreign exchange guarantees for Indonesian companies that had reached restructuring agreements, was not successful. In contrast, JITF whose mandate was to provide technical support for debt restructurings and administer the out-of-court debt workout framework has overseen the restructuring of roughly $20 billion in corporate external debt through June 2003.

[36] Clearly, if the government had been in a position to implement the kind of policies needed to validate a currency board, they would not have needed a currency board in the first place.

III. RECENT PERFORMANCE OF THE INDONESIAN ECONOMY AND REMAINING CHALLENGES

Indonesia's economic reform program, supported by the IMF, has been successful in restoring macroeconomic stability and advancing important structural reforms. Assessing performance as of June 2003, the exchange rate has appreciated considerably, to near Rp 8,000 per U.S. dollar; inflation is back to single digits (under 7 percent in June); and interest rates have declined sharply-from nearly 18 percent in December 2001, to roughly 9 percent today-thus providing support for economic recovery. Major progress has also been made towards restoring a healthy and sustainable budget position. As a result of this success, and helped by the appreciation of the rupiah, Indonesia's public debt burden declined by roughly 20 percentage points to 83 percent of GDP, between 2000 and 2002. External vulnerability has been reduced markedly, with the reserve cover of short-term debt having been increased from about 85 percent at end 2000, to about 150 percent at present. These developments have resulted in a virtuous circle manifested in the recent performance of the financial markets, which have surged (thus mirroring the positive performance of markets in much of the rest of the world) since the end of hostilities in Iraq, The stock market is lip sharply, and short-term capital flows have increased.

Good progress has also been made in key areas of structural reform, namely IBRA asset recovery, and bank divestment and restructuring. After getting off to a slow start (due in large part to political intervention) following its creation in 1998, IBRA has successfully recovered over Rp 110 trillion in cash (and roughly Rp 17 trillion in bonds) from bank-related assets pledged to the government during the crisis. These recoveries have played an important role in reducing the public debt. Bank divestment has also been successful, with majority stakes in BCA, Niaga, and Danamon having been sold in competitive, transparent tenders. The recent IPO for Mandiri has also been a success. These divestments have significantly buoyed investor sentiment towards Indonesia. The government's efforts to strengthen the banking system, for example through the gradual increase in the mandatory capital adequacy ratio and the creation of a comprehensive financial sector safety net, have also been of critical importance for strengthening Indonesia's market infrastructure and thus supporting investment.

Progress has been less rapid in other important structural areas. Decentralization, which on the whole has been implemented relatively successfully, has raised problems for both existing businesses and prospective investors, in the form of new and conflicting regulations and taxes. The investment climate more broadly considered also remains weak. The slow pace of reform in the legal and judicial sphere has been highlighted in the last two years by several high-profile legal cases involving foreign investors. While these cases clearly matter for Indonesia's international reputation as an investment destination, the impact of these Institutional weaknesses on the domestic investor may be even greater. Weaknesses in Indonesia's legal infrastructure, for example those related to the commercial court, have also resulted in slower corporate restructuring than needed for economic recovery.

Indonesia-IMF relations since the crisis

An active policy dialogue between Indonesia and the IMF has supported the government's economic reform strategy. (Information on Indonesia's IMP arrangements is provided in Table 2.) Indonesia's Fund-supported programs, set out in the now publicly-released LOIs, have encapsulated the main elements of the government's overall economic and financial policies. In this sense, the LOIs reflect the policies and objectives that are included in the government's domestic policy documents, such as the PROPENAS (5-year strategy), the REPETA (annual strategy), and the budgets. As was the case during the crisis, the targets set by the government in their LOIs have been adjusted over time (when needed) based on actual macroeconomic and structural priorities and developments.[37]

Table 2. Indonesia: Arrangements with the IMF, 1997-2003

			Access		Amount Drawn 4/	
	Approval Date	Expiration Date	SDR bns	US$ bns	SDR bns	US$ bns
Stand-by Arrangement (SBA) 1/	November 5, 1997	August 25, 1998	8.3	11.4	3.7	4.9
Extended Fund Facility (EFF) 2/	August 25, 1998	February 4, 2000	5.4	7.2	3.8	5.2
Extended Fund Facility 3/	February 4, 2000	December 31, 2003	3.6	5.0	2.9	4.0

Source: Finance Department (IMF).

1/ The SBA originally granted access of SDR 7.3 billion. This was increased to SDR 8.3 billion in July 1998. The SBA was originally agreed for a three-year period, but was replaced by an EFF in August 1998.
2/ The EFF originally granted access of SDR 4.7 billion. This was increased to SDR 5.4 billion in March J 999. The EFF was originally agreed for a three-year period, but was renegotiated in February 2000.
3/ The second EFF was extended by one year in November 2002.
4/ Total amount drawn by the end of each arrangement, and through end-June 2003 for the current EFF.

IMF staff and their Indonesian counterparts in government ministries and agencies have met regularly (roughly every three months) to review recent economic and financial developments and discuss the outlook for the Indonesian economy. Topics which are central to the discussions include fiscal and monetary policy, the ongoing reform of the financial sector, and various structural reforms that are of particular importance for the investment climate. During Article IV consultations (which occur on an annual basis), the remit of the discussions has been broader, including other areas of importance to Indonesia's socioeconomic development (such as labor, the environment, education, and health). The objective in these consultations is also to step back in order to assess progress being made by Indonesia toward meeting its medium- and long-term development goals.

The IMF has aimed to increase its efforts to exchange views on economic policies with other actors in Indonesia's civil society, including parliamentarians; NGO and trade union representatives; members of the print, radio, and television media;

[37] For example, following the Bali bombing in October 2002, the preliminary fiscal deficit target for 2003 was increased to support domestic demand and provide assistance to the sectors and regions adversely affected by the attack.

academics and economic researchers; and private sector representatives from commercial banks, investment banks, and business. This builds on the efforts made by the IMF during the Asian crisis to reach out to the political opposition and other members of the body politic, so as to increase public understanding and support for the reform program. Through these contacts the IMF aims to improve its understanding of economic and financial conditions in Indonesia and of where the emphasis of future reform efforts should lie. In addition, increased contacts with various segments of Indonesian civil society have allowed the IMF to better explain its role to the Indonesian public. The IMF's resident representative, based in Jakarta, plays a critical role in all these efforts.

Remaining challenges to Indonesia's economic recovery

While the positive macroeconomic and financial developments over the last year are encouraging, it may take some time for them to be translated into higher investment and economic growth. For example, although interest rates have fallen considerably in the last year, the transmission of these lower rates into greater credit for businesses has not yet occurred, with bankers still wary to lend in the continued absence of a robust legal system. Also, while the recent interest in Indonesian financial markets is encouraging, much of the recent inflow of capital has been short-term in nature, and market sentiment toward Indonesia remains fragile; policymakers will need to be prepared for a possible reversal of these flows.

Tackling the remaining weaknesses of Indonesia's investment climate is critical for attracting the domestic and foreign capital needed to increase growth over the medium term. In the last few years, economic growth has been sustained at 3-4 percent per year, even in the face of large domestic and external shocks. Although this rate of growth would certainly be envied by most industrialized economies, it will need to accelerate for Indonesia to reduce unemployment and poverty in a meaningful way. A significant step-up in investment, both foreign and domestic, will be critical in this regard. However. Indonesia's investment climate is still considered very weak by international standards, and significant progress will be needed to alter this perception.[38] Key areas of concern cited by domestic and foreign investors include the following:

- *Decentralization*. Continued care will need to be taken that decentralization does not lead to all unduly complex and unstable regulatory framework that discourages investment.
- *Custom and tax administration*. Reportedly, there has been a deterioration in recent years in terms of transparency, predictability, and fairness.[39]

[38] Indonesia was ranked 99th out of 161 nations in the 2002 Index of Economic Freedom (compiled annually by The Heritage Foundation), behind Cambodia and the Philippines.

[39] The IMF has been providing extensive technical assistance to Indonesia in this area.

- *Labor market policy*. Given the importance to investors of labor costs and related issues, a balance in labor market policy is needed between protecting workers rights and preserving a flexible labor market.
- *Legal and judicial sector reform*. Key steps would include the creation of the Anti-Corruption Committee, passage of pending amendments to the bankruptcy law, and continued efforts to strengthen the commercial court.

To support consumer and investor confidence, the strong ownership of the reform agenda which already exists will need to be consolidated and more forcefully conveyed to the public and the markets. As noted recently by Finance Minister Boediono, strong steps in this regard, notably the government's plan to present a comprehensive economic reform program for 2004 in the near future, will be essential to address the potential “credibility gap” that may emerge following the expiration of the current IMP arrangement.[40]

Enhanced transparency with regard to the government's institutional reform agenda will also be important for boosting confidence. In this connection, Indonesia could benefit from adopting and implementing forcefully the codes, standards, and best practices for economic and financial data that have been promulgated in the international community since the Mexican and Asian crises (mid-to late 1990s). Transparency can help economies function better and makes them less vulnerable to crisis. Greater openness on the part of member countries encourages more widespread discussion and examination of member’s policies by the public; it enhances the accountability of policy makers and the credibility of policies, facilitates efficient functioning of financial markets, and improves governance.[41] Regular provision of information to the public on statistics and on policy intentions can also provide greater stability to financial markets.

Indonesia's participation in these transparency efforts has unfortunately been very limited to date. Although the Indonesian government now publishes its LOIs, the government has not approved the publication of any of the staff reports on Indonesia prepared by the IMF staff for the Executive Board. In addition, Indonesia has yet to participate in any of the IMF's Reports on the Observance of Standards and Codes (ROSC) modules, which assess the extent to which countries observe certain internationally recognized standards and codes.[42] A number of Asian countries (including Hong Kong SAR, India, Korea, Malaysia, Philippines, and Sri Lanka) have

[40] Public remarks made by Finance Minister Boediono at USINDO (Washington, D.C.) on April 11, 2003.

[41] A fact sheet describing progress in promoting greater transparency among IMF member countries can be found at http://www.imf.org/external/np/exr/facts/transpar.htm

[42] The IMF has recognized 12 areas and associated standards as useful for the operational work of the Fund and the World Bank. These comprise accounting; auditing; anti-money laundering and countering the financing of terrorism; banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation. See http://www.imf.org/external/np/rosc/rosc.asp for more information.

already completed ROSCs, thus obtaining valuable information on how to strengthen their institutional frameworks. Indonesia may also wish to consider future participation in the Financial Sector Assessment Program (FSAP), undertaken jointly by World Bank and IMF staff, which aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries.[43] Undertaking such an assessment would support Indonesia's ongoing efforts to strengthen the financial system.

IV. KEY FEATURES OF IMF-MEMBER RELATIONS

Indonesia's strategy as it concludes the current arrangement with the IMF has become a much-debated topic in Indonesia. Since there appear to be some misconceptions regarding the nature of Indonesia's membership in the IMF more generally, we present some information about what membership m the IMF actually entails (Box 1).[44] IMF membership conveys, a certain number of benefits, such as access to exceptional financing at times of balance of payments need, and availability of technical assistance on a wide range of issues. IMF members also participate actively in the formulation of IMF policy, through their official representation on the Fund’s Executive Board. In exchange for these benefits, member nations pledge to manage their economic and financial policies in a manner that is compatible with promoting global economic and financial stability.[45] Membership is not at all related to, having a borrowing arrangement with the IMF. In fact, at the moment only 56 of the IMF's 184 member nations have a Fund arrangement (including four that are precautionary). This. Indonesia’s membership in the IMF, along with its benefits and commitments, will continue after the expiration of the current financial arrangement with the Fund.

The nature of Indonesia's future relationship with the IMF will be decided by Indonesia’s, based on what best supports the nation's economic and development strategy. Regardless of the specific form of Indonesia’s relationship with the IMF, the most critical instrument to reach these goals will be the government's implementation of an economic program that provides macroeconomic stability and advances structural reforms. Macroeconomic stability is widely agreed to be a necessary, although not sufficient, condition for growth, and development. Structural reforms – in all countries and at all times – are required to develop and maintain the institutional infrastructure that serves to underpin the private, market economy.

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43 Supported by experts from a range of national agencies and standard-setting bodies, work under the FSAP seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritize policy responses. Information on the FSAP can be found at http://www.imf.org/external/np/fsap/fsap.asp

44 Indonesia originally joined the IMF in April 1954, withdrew in August 1965, and rejoined In February 1967. There are currently 184 member countries in the IMF.

45 These commitments, which have been made by all IMF members are set out in the IMF's , Articles of Agreement (see http://www.imf.org/external/pubs/ft/aa/index.htm)

Once the government, in consultation with Parliament and civil society, has identified the core elements of Indonesia's future economic program, it will be in a position to identify the optimal relationship for Indonesia with the IMF. This determination should be based on what will be in Indonesia's best interest. The following questions might be useful in making this determination:

- Will exceptional financing from the IMF or the Paris Club of official bilateral creditors be needed?
- Would the formulation and assessment of economic policies be strengthened by periodic discussions with IMF staff or management?
- Would a closer relationship with the IMF provide greater confidence to other official creditors (e.g., the World Bank and the Asian Development Bank) and to financial markets and investors?
- Will Indonesia require technical assistance in the areas of policy design and implementation?

Based on the answers to these questions, the most suitable relationship with the IMF can be identified. The main benefits available to a member from the IMF, and the conditions under which they can be obtained, are set out below (and summarized in Table 3).

- *Exceptional financing*. Under an *arrangement*, a member has access to financial resources from the IMF when it has a proven balance of payments financing need. This exceptional financing, which is available at interest rates considerably below those charged on commercial financing, allows a country's foreign reserves to be bolstered, thus supporting its external position and its currency (Table 4 shows the general terms of IMF financial assistance). In the case of a *precautionary arrangement*, under which resources are committed by the Fund and available to the member the member indicates that it does not intend to use the financing unless its balance of payments position weakens from the project path. Under such an arrangement, market confidence is supported by the knowledge that exceptional financing is available if needed.

- *Financing from the Paris Club* (i.e., rescheduling of government debt owed to official bilateral creditors) is possible only in the context of a Fund arrangement. This is because the Paris Club (i.e., the official bilateral creditors) requires independent assurance (from the EMF) that a country's request for debt rescheduling is motivated by a true balance of payments, need and that its situation requires relief on its scheduled debt service payments. In addition, the creditors need to be assured that a strong reform program will be implemented during the period of debt rescheduling, so as to safeguard the country's debt service capacity at the end of the rescheduling period. The Paris Club does not provide exceptional financing under a *precautionary arrangement*, given that such arrangements project no external financing gap during the period covered by the arrangement.

Table 3. Benefits Under Various Relationships with the IMF

	Arrangement	Precautionary Arrangement	Post-Program Monitoring	Surveillance
Financing from IMF	✓	✓	×	×
Financing from Paris Club	✓	×	×	×
Policy endorsement 1/	✓	✓	×	×
Letter of Intent (LOI)	✓	✓	×	×
Assessment of policies by the IMF	✓	✓	✓	✓
Policy dialogue	✓	✓	less frequent 2/	infrequent 2/
Public information 3/	✓	✓	less frequent	infrequent
Technical assistance	✓	✓	✓	✓

1/ Clear and consistent with certain standards.
2/ Generally less frequent than under an arrangement for the use of Fund resources, but can be more frequent at the request of the authorities.
3/ The information released is at the discretion of the authorities and may include LOIs, staff reports, and other IMF-related documents. The IMF itself encourages its member countries to be as forthcoming as possible as regards the publication of such documents.

- *Endorsement of the member's economic policy*. Regular endorsement of the member's economic program by an independent institution like the IMF can enhance the government's credibility and support confidence in the outlook for the economy.[46] This endorsement, and the accompanying monitoring of policy implementation, can

[46] It should be acknowledged, however, that the IMF' endorsement only generates support in cases where the government has demonstrated clear ownership of the program. In the absence of such ownership, questions inevitably arise about the government's ability and willingness to implement the measures contained in the program.

be particularly important in the context of a political transition, when uncertainty with regard to the future direction of economic policy, and the temptation to slant policy toward political needs, is at its greatest. Under an *arrangement*, IMF endorsement is provided in the initial approval of the arrangement by the Executive Board, and the Board's subsequent conclusion of program reviews on satisfaction of agreed-upon policy performance criteria, as set out in the arrangement. There is no such formal endorsement of a member's policy under *post program monitoring or surveillance*.

Table 4. General Terms of IMF Financial Assistance

Facility of Policy	"Charges" (Interest)	"Repurchase" (Repayment) Terms Obligation Schedule (Years)	Expectation Schedule /2 (Years)	Installments
Stand-by Arrangement (SBA)	Basic rate plus surcharge /1	3¼ - 5	2¼ - 4	Quarterly
Extended Fund Facility (EFF)	Basic rate plus surcharge /1	4½ - 10	4½ - 7	Semiannual
Compensatory Assistance	Basic rate	3¼ - 5	2¼ - 4	Quarterly
Emergency Assistance	Basic rate /3	3¼ - 5	Not applicable	Quarterly
Supplemental Reserve Facility	Basic rate plus 300-500 basis points	2½ - 3	2 - 2½	Semiannual
Contingent Credit Lines	Basic rate plus 300-500 basis points	2 - 2½	1 - 1½	Semiannual
Poverty Reduction & Growth Facility	0.5 percent per annum	5½ - 10	Not applicable	Semiannual
Memorandum Items:				
Current basic rate of charge (Q2 2003)	2.1 percent			
Service charge	0.5 percent			
Commitment fee 4/	25 basis point on committed of up to 100 percent of quota, 10 basis points thereafter.			

Source: Finance Department (IMF).

1/ Surcharges are applied to the combined credit outstanding under the SBA and EFF of 100 and 200 basis points, respectively, on the amounts in excess of 200 percent and 300 percent of quota, respectively.

2/ Disbursement made after November 28, 2000 - with the exception of disbursements of emergency assistance and loans from the Poverty Reduction and Growth Facility (PRGF) – are expected to be repaid on the expectation basis.

3/ And administered account was set up in May 2001 to subsidize the basic rate of charge on post – conflict emergency assistance to PGRF-eligible countries to 0.5 percent per annum.

4/ The annual commitment fee is charged on the amount available under an arrangement during the year. The fee is refunded to the extent the available amounts are purchased. The commitment fee applies only to Stand-by and Extended Arrangement, including amounts available under the Supplemental Reserve Facility and Contingent Credit Line.

Table 5. IMF Arrangements with Selected Members

	Mexico SBA (1995)	Korea SBA (1997)	Thailand SBA (1997)	Brazil SBA (1998)	Russia SBA (1999)
Arrangement – key dates					
Approval	02/01/1995	12/04/1997	08/20/1997	12/02/1998	07/28/1999
Last Purchase	12/21/1995	05/20/1999	06/21/1999	12/09/1999	07/30/1999
Did agreement turn precautionary?	Yes – 08/1996	Yes – 12/17/1999	Yes – 09/22/1999	Yes– 04/20/2000 1/	No 2/
Expiration of arrangement	02/15/1997	12/03/2000	06/19/2000	09/14/2001	12/27/2000
Post – program monitoring (PPM) – key dates					
Decision by Executive Board on PPM 3/	--	08/23/2000	09/15/2000	--	09/20/2000
Completion of PPM	--	08/01/2001	08/02/2002	--	03/08/2002
Key financial information (SDR millions)					
Access under arrangement	12,070	15,500	2,900	13,025	3,300
Total purchases made	8,758	14,413	2,500	9,471	471
Financial indicators at conclusion of Fund arrangement					
Reserves (US$ billions, unless otherwise indicated)					
Gross	19.6	96.2	34.8	35.9	27.9
In month of imports	2.8	6.0	6.7	5.9	4.6
In percent of short-term debt	32.6	153.2	122.7	129.7	89.4
Net	6.3	96.2	26.4	27.8	16.3
Sovereign debt issuance in year of conclusion (US$ billions)	7.2	0.0	0.30	3.9	0.0
Sovereign credit rating (S&P) 4/	BB	BBB	BBB-	BB-	B-

1/ Although Brazil's 1998 SBA turned precautionary in April 2000, drawings were made again beginning in June 2001 due to a deterioration in the external financing environment.

2/ Russia 1999 SBA went off-track, and no program reviews were completed (and hence no further purchases were made) during arrangement.

3/ The IMF decided in mid-2000 that when a members credit outstanding exceeded a threshold of 100 percent of quota, there should be a presumption that the member would engage in PPM after the expiration of its arrangement. The decision to engage in PPM is usually made at the Board meeting for the last review of the arrangement. In the case of Thailand, whose arrangement concluded before the Board's PPM decision, PPM commenced after the end of the arrangement. Brazil agreed a successor arrangement following the conclusion of its 1998 SBA (hence no PPM).

4/ Standard & Poor's long-term sovereign credit rating for external debt. A country rated BBB of higher is considered "investment grade", with "adequate capacity to meet its financial commitments", while issuers rate BB and B are considered "speculative grade", with greater vulnerability to nonpayment of obligations.

Table 6. Projected Payments to Fund (Expectations Basis), 2004 - 10
(in millions of SDR unless otherwise noted; based on exiting use of resources and present holdings of SDRs) 1/

	2004	2005	2006	2007	2008	2009	2010	Total
Principal	678	775	1,016	1,360	1,704	942	441	6,915
Charges/Interest	191	171	149	126	93	62	42	835
Total	869	946	1,165	1,486	1,797	1,004	483	7,750
Memorandum items:								
Total payments (US$ mns)	1,197	1,230	1,514	1,932	2,336	1,305	628	10,142
Outstanding IMF debt (SDR mns)	6,237	5,462	4,447	3,087	1,383	441	0	…
as a percent of quota	300	263	214	148	67	21	0	…
Outstanding IMF debt (US$ mns)	8,588	7,101	5,781	4,013	1,798	573	0	…

Source: Finance Department (IMF).

1/ As of June 30, 2003, SDR 1 = US$ 1.40.

- *Policy dialogue*. The discussion and monitoring of economic policies occurs most frequently during an arrangement (normally 2-4 times per year), with access to IMF financing conditional on satisfactory implementation of an agreed policy program (set out in the LOI), as assessed in regular reviews. In the case of a precautionary arrangement, performance against an agreed policy program is also assessed in regular reviews. Under *post-program monitoring*, a member engages in discussions with IMF staff on its policies, including a quantified macroeconomic framework; however, there is no LOI.[47] Staff report formally to the Board (normally twice a year) on their discussions with the member, including the consistency of the member's policies with the objective of medium-term viability, and the implications for the member's capacity to repay the Fund. Under *surveillance* (i.e. Article IV consultations), the IMF maintains a similar dialogue with the member on the national and international consequences of their economic and financial policies. However, although there may be more than one staff visit to the member country each year, a formal discussion at the Executive Board occurs only once a year.

- *Public release of information*. Under an *arrangement*, program reviews provide the opportunity for regular information updates to the markets and the public at large of the member's current economic situation and future prospects. At the conclusion of each program review, the Board issues a Public Information Notice (PIN) which summarizes the staff assessment ~as presented in the country staff report prepared for the Board) as well as the Board's views.[48] Information is generally released somewhat less frequently outside the context of an arrangement. Under *post-program monitoring*, usually two PINs per year can be issued, while under surveillance, there could normally be one per year (on the occasion of the Article IV consultation). In all cases, additional information can be made available to the public if the authorities approve the publication of the staff reports and other documents. There are various other opportunities for the IMF to provide public information updates to the public. In the case of Indonesia, these include meetings of the Consultative Group for Indonesia and other such occasions.

- *Technical assistance*. Members have access to IMF staff expertise at any time (Box 2 lists the key areas of T A to Indonesia since 1997). Requests for such assistance are considered in the broader context of the needs and requirements of all IMF members.

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[47] A member with a substantial amount of outstanding IMF credit (typically more than 100 percent of quota) is expected to engage in Post-Program Monitoring (PPM) by the Fund of economic developments and policies after the expiration of its arrangement. While the key focus of PPM is to safeguard the repayment of the member's debt to the IMF, the best safeguard of these claims is the improvement in economic performance of the member country. Hence, there is a strong alignment of the IMF's interests with those of the member.

[48] Although not yet mandatory, it is increasingly becoming the norm for staff reports to be published. Publication of the staff report requires the approval of the country's authorities.

Irrespective of Indonesia's upcoming decision regarding its relationship with the IMF for 2004, all options remain available at any time in the future. While it is certainly the expectation that Indonesia will continue on its current favorable path of economic growth, macroeconomic stability, and structural reforms, exogenous shocks may occur that could jeopardize Indonesia's external viability. In such a situation, Indonesia, like any IMF member facing balance of payments problems, would be able to request IMP financing.

V. POST-CRISIS RELATIONS OF OTHER LARGE COUNTRIES WITH THE IMF

In assessing its strategy for the period following the expiration of the current IMF arrangement Indonesia may wish to consider the experience or other countries that have faced many of the lame Issues as Indonesia does today, e.g., recovery from financial crisis, uncertain external financing conditions, and political uncertainty.[49] Table 5 presents indicators of a few selected countries' use of IMP financing, and of their financial condition as they concluded their IMP arrangements.

- In all the selected cases (except for Russia, whose program went off-track shortly after it was approved), members maintained an arrangement with the IMF following the apparent and of their need for exceptional financing, as indicated by the fact that their arrangements turned precautionary at some point before they concluded. This suggests that these countries believed that an arrangement with the IMP provided benefits beyond the exceptional financing provided under the arrangement.
- In all countries (apart from Brazil, which agreed a successor arrangement), post-program monitoring took place following the end of the arrangement, for varying periods of time. As their financial conditions improved, most countries made some early repayments.[50]
- The countries in the sample appeared to be in a somewhat stronger position vis – a – vis global financial markets than Indonesia is today. Considering sovereign credit ratings, all countries (apart from Russia) had S&P ratings that were several grades above Indonesia's current B – rating.
- The role played by the IMF arrangement in underpinning market sentiment toward Brazil during the highly charged 2002 presidential campaign is worth noting. The fact that all presidential candidates, including the Workers' Party candidate (and current President) Lula da Silva, committed in principle to support the government's Fund-supported program. considerably lessened investor uncertainty with regard to the continuity of macroeconomic policies and structural reforms.

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49 The comparator countries are Korea, Thailand, Brazil, Mexico, and Russia, all large countries that have experienced financial crises and have had Fund-supported programs in recent years.

50 Indonesia's IMF debt repayment schedule is presented in Table 6.

VI. LESSONS LEARNED FROM INDONESIA'S CRISIS AND CONCLUDING THOUGHTS

The experience of Indonesia has taught both the IMF and country authorities important lessons for preventing and handling financial crises.

- The need for an in-depth understanding of potential fragilities in the financial and corporate sectors, and for adequate institutions to monitor and address these fragilities, has been a key lesson. The IMF and the World Bank have increased substantially the number of staff with expertise in these areas, and balance sheet analysis, which aims to quantify these fragilities, has become an important (and growing) component of IMF surveillance. More generally, surveillance of the financial sector has been intensified, including through the FSAP.
- The importance of transparency and of an effective communications strategy for managing public and market expectations has become well appreciated. While the IMF now attempts to incorporate public perceptions in program design, more could still be done, by country authorities and the IMF to make the design of IMF-supported programs a more participatory process.
- The success of any Fund-supported reform program depends critically on government ownership. In order to maximize the likelihood of success, the Fund assesses carefully the commitment of the authorities to a reform strategy before financing is approved.
- Support for the reform program by the country's body politic is also a key requirement for its success. The IMF has increased its efforts to reach out to civil society, both to solicit nongovernmental actors' views on the reform program, and to increase understanding of the role played by the IMF in the member country.

Regarding whether the policy advice given by the IMF to Indonesia during the Asian crisis was correct, differences of view will likely persist for a long time. The critical issue going forward, however, is that the government build on Indonesia's successful recent performance, by designing and implementing an economic reform program that supports macroeconomic stability and continues advancing institutional and structural reforms. This paper has aimed to layout some of the issues that Indonesians may wish to consider as they decide what type of relationship with the IMF will suit them best in the future. Whatever the choice may be, the IMF will stand ready, as it does for all member countries, to assist in the manner deemed most appropriate by Indonesia.

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