Anatomy of a disaster: the IMF’s war on corruption in Indonesia and the effects of structural adjustment

Georgia Lysaght
University of Wollongong
NOTE

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Chapter 1

Introduction

1.1 Background

The year 2007 marked a decade since the onset of the Asian financial crisis. While the focus upon this event has not received the intensity of late that it had up until the turn of the millennium, the impacts of the crisis itself and the International Monetary Fund (IMF) reforms instigated are still evident throughout the region, particularly in Indonesia. From the second half of the twentieth century, East and Southeast Asia surprised the rest of the world by developing at a rapid, albeit bumpy pace. By the late 1980s, despite rising oil prices and debt, it was evident that Indonesia, Malaysia, Thailand, and to a lesser extent, Vietnam, were following the rapid economic growth path of their regional and historical predecessors, Japan, Taiwan, Singapore, South Korea and Hong Kong. At a time when neo-liberal ideas of open commerce and free trade were becoming increasingly influential, Asia, and Southeast Asia in particular, was ‘hot’ and foreign capital flowed in at an overwhelming rate. During the 1980s and early 1990s, these countries were dubbed the ‘Asian Miracle’ by many proponents of neo-liberalism, best represented perhaps by the World Bank’s 1993 study,\(^1\) where it was proposed that Indonesia, Malaysia and Thailand “…may show the way for the next generation of developing economies”.\(^2\)

Just a few years later Indonesia was caught up in the financial crisis that involved, to varying degrees, all of East Asia. The crisis was triggered as a result of investor panic, which began in June 1997 in Thailand, and spread rapidly. As a result, currencies and markets in East Asia plummeted, subsequently devastating the previously internationally heralded ‘miracle economies’. Thailand, South Korea, Indonesia and Malaysia were the four countries most severely affected by the crisis.\(^3\) The overwhelming majority of Indonesian debt was in the form of private sector unhedged short-term debt owed to foreign creditors, and was predominately in US

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dollars. Due to the rapid depreciation of the rupiah, the amount owed increased to unserviceable levels.

The immediate response of the Indonesian government to the crisis was to float the rupiah, which was suffering severe downward pressure. This, and the selling of international reserves, were the initial measures enacted by the government in an attempt to at least soften the blow and restore stability to the exchange rate and prevent dire economic contraction. However, these responses failed to safeguard Indonesia from a full-fledged crisis toward the end of 1997. As a consequence, nervous creditors were hesitant to reschedule debt or extend new loans, and investors lacking in confidence pulled money out of Indonesia, leading to a significant contraction in the size of the economy. The waning of investor/creditor confidence was followed by a further decline in the exchange value of the rupiah and these two factors continued to influence each other until the rupiah bottomed out in 1998 at 20 per cent of its pre-crisis value. In September 1997, the Suharto government had little choice but to request the intervention of the IMF, as had the governments of Thailand ($17.2 billion program) and South Korea ($58 billion program). Malaysia was the only country of the four that declined any IMF financial assistance. The Fund’s US$10 billion regional bailout package to Indonesia formed part of an overall rescue package totalling US$43 billion that was subsequently initiated. The IMF package consisted of an extensive series of prescriptions designed not only to assist Indonesia in its immediate crisis situation, but also to reform the country’s economy and political system by replacing its existing protected economic framework with a market driven model.

Indonesia was particularly affected by the East Asian crisis because the dire financial conditions of the economy were accompanied by severe political instability and social unrest. An ailing President Suharto also increased social tension through his seeming refusal to act in the interests of the Indonesian people whilst protecting the interests of his associates and family. This tension was further exacerbated by the International Monetary Fund (IMF), which initiated programs that, although they involved enormous sums of credit, seemed to affect little improvement as the situation continued to decline. Asia, and indeed Indonesia, are very different places to what they

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were ten years ago. Despite the changes that have taken place, there are still lessons to be learned from the past decade, and these lessons are the subject of this thesis.

1.2 Thesis Argument

This thesis sets out to deconstruct and examine a number of inter-related issues. It first assesses neo-liberal attitudes regarding the functioning of developing states and indeed the neo-liberal argument of how developing states should change in this process. Second, it examines the way in which corruption responds to various power structures in developing states, specifically Indonesia. Third, it reviews the impact of externally imposed political and economic reform on corruption under the auspices of a neo-liberal, international institution backed by the Western capitalist governments of the United States (US), the United Kingdom (UK), Germany, France, and Japan who are the major stakeholders in the in the IMF and World Bank. The line of argument drawn from these issues will provide a framework whereby the question of the relationship between corruption and market sentiment, in particular foreign direct investment (FDI), can be addressed. This is done so as to present an alternative view that challenges the attitude of western governments towards developing states, namely neo-liberal economics is normative and that the so-called free market responds favourably only to open and deregulated economies. This thesis also challenges the appropriateness of the International Financial Institutions’ (IFIs) position as an advocate of a wider US-led globalisation project.

Neo-liberalism (and neo-liberal economics) is defined here as a belief in the rationality of the free market system and its capacity to produce outcomes that are beneficial to all. It is characterised by an advocacy of policy shifts towards private ownership of enterprise, a minimal role of government in the national economy, and the pursuit of almost complete economic deregulation. These central tenets are embodied by the Washington Consensus. The IMF is an example of an institution that represents this school of thought, specifically in regard to protective economics and the impact of corruption on foreign direct investment. While the neo-liberals had argued in the past that the East Asian miracle was a result of the adoption of Washington Consensus’ compliant policies by governments in that region, the onset of the Asian financial crisis immediately undermined this claim. Thus the neo-liberals were faced with the dilemma
whereby they sought to explicate the cause of the crisis without contradicting the claims they had made previously about the reasons behind East Asia’s economic growth. Importantly, Jayasuriya and Rosser comment on the conflict that emerged amongst the neo-liberals in their attempts to explain the reasons for the Asian crisis. They identify the three main reasons espoused by the differing neo-liberal camps as to the cause of the Asian crisis: 1) The government failure / crony capitalism thesis, 2) The macroeconomic mismanagement thesis, 3) The premature financial liberalisation thesis. The premise of the premature financial liberalisation thesis departed significantly from the other two, as it focused on the role of the international financial system in creating and exacerbating the crisis, rather than exclusively internal governance-related problems. In noting the differing opinions about the Asian crisis amongst the neo-liberals, Jayasuriya and Rosser state that “this dissension is best illustrated by the fact that Joseph Stiglitz, the World Bank’s chief economist between February 1997 and February 2000, openly disagreed with the International Monetary Fund’s management of the crisis which…was based on the application of the Washington consensus”. However, it was the IMF which took the lead in creating programs for Thailand, Indonesia and South Korea to remedy what it saw as the causes of the crisis.

Corruption was indeed identified by the IMF as one of the chief causes of the Asian financial crisis. However, prior to the crisis, the issue of corruption was somewhat peripheral to international observers such as the World Bank and IMF, particularly during the Cold War and in the immediate post-Cold War era. The assumption that corruption caused the Asian crisis is problematic and it is difficult to isolate as a factor firstly because corruption occurs everywhere throughout the world, and secondly because high levels of corruption existed alongside high levels of economic growth and FDI in Indonesia during the latter 1980s and first part of the 1990s. Decisions affecting the economy, planning and development were made in the

interests not of the state or collective, but of the governing and business elite who were tied inextricably to the state. Although the anti-corruption strategies directed by the IMF were pervasive, corruption not a factor in the ‘Asian Miracle’ scenarios. It has been argued that at the end of the Cold War, the dictatorships of the Third World lost a significant degree of the bargaining power as these leaders could no longer use the ‘Soviet PRC Card’ against the US government.\(^8\) Subsequently, the Washington based institutions could exercise more influence throughout the developing world without the need for the US to “waltz with dictators to legitimize and manage its leading role”.\(^9\) Thus, the IMF and World Bank as part of the US, could begin to demand changes to non-capitalist aspects of states in the developing world without the threat of any real global opposition.

The IMF’s Indonesia program attempted to diffuse the power of the central government and thus insulate the economy from vested interests. However, the decentralisation program that was implemented only succeeded in fragmenting power. In a decentralised system corruption became far more destructive to economic development and FDI than under a centralised system of governance where it was subject to checks and balances. Under a more protective economic system, the state was able to regulate FDI and steer the economy in the direction necessary to promote growth, including promoting the private interests of Indonesia’s elite. The so-called liberalisation of Indonesia’s economy under the auspices of the IMF resulted in a climate of uncertainty and subsequently an economic slump. The central government, having relinquished central economic control to the market, then lacked the capacity to regulate. The outcome was a decade of social chaos, economic contraction and the creation of decentralised corruption that has crippled Indonesian economic growth and skewed social development ever since. Thus the modest equitable progress that was engineered under Suharto was subsequently reversed, largely as a result of the IMF-directed programs.

\(^8\) T. Kivimaki, ‘U.S.- Indonesian Relations During the Economic Crisis: Where has Indonesia’s Bargaining Power Gone?’, *Contemporary Southeast Asia*, 22(3), December 2000, p. 531 (527-549)

\(^9\) T. Kivimaki, ‘U.S.- Indonesian Relations During the Economic Crisis', p. 528
1.3 Methodology

A range of sources have been consulted to provide the evidence upon which this dissertation is based. In regards to the actual IMF program in Indonesia, most of the evidence is based upon primary sources, including IMF documents, Government of Indonesia’s Letters of Intent (LOI), public statements in regards to Indonesia and the extended region, and IMF papers that address the financial crisis and related topics. These sources include databases and statistics from the World Bank, Asian Development Bank (ADB), IMF, and United Nations (UN) assessments that provide empirical data pertaining to the region and Indonesia’s economic indicators. Furthermore, in 1995 Transparency International released its first (of now annual) corruption perceptions index (CPI),\(^\text{10}\) based on surveys conducted in countries throughout the world. The CPI is an important source particularly in the context of this thesis, as regardless of actual corruption levels, it provides an insight into how corrupt a country is perceived to be investors and business people.

This thesis however provides a more extensive exploration of corruption and economic change that does not rely solely on empirical evidence. It examines a body of qualitative sources that contributes to explaining why and how the documented changes to corruption and Indonesia’s economy occurred. Fieldwork was carried out in Jakarta, Bali and Yogyakarta Indonesia during 2005 with some follow up correspondence in 2006 and 2007. The majority of fieldwork was carried out in the form of interviews with foreign and national business people, academics, and ex-government ministers. Some of the interviewees have expressed the wish to remain anonymous, and accordingly this has been respected.

These sources have centred the research and they highlight what the interviewees believed to be the problem areas of the IMF’s program, and the impediments to doing business for foreigners in post-crisis Indonesia. For example, an interview with ex-Coordinating Minister for Economic Affairs, Rizal Ramli, provided insights into the extent to which the IMF program affected Indonesia’s economic condition. Ramli asserted that the IMF’s program increased economic contraction.

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\(^{10}\) Transparency International, ‘Surveys and Indicies’ www.transparency.org/policy_research/surveys_indices/cpi, (date if access 21 May 21, 2008).
beyond what was initially inevitable when the crisis first struck.\textsuperscript{11} Other interviews conducted with foreign investors in 2005 who were operating in Indonesia during the 1997-1998 crisis have provided insights into the subsequent reactions of foreign capital lenders and investors. Extended interviews with executives of international companies in Indonesia caught up in the fallout from the crisis provided insightful accounts into the problems of the IMF’s reform of the banking sector. In particular, one informant noted the shoddy effort to recoup funds through selling insolvent banks’ assets, the inappropriate manner in which many insolvent banks were closed, and the Fund’s aversion to consultation, preferring instead a ‘top-down’ approach.\textsuperscript{12} This thesis argues that the application of fiscal and monetary austerity to a country that had recorded a stable and well managed macroeconomy served only to exacerbate economic contraction and human suffering.

Most interviewees viewed the IMF as incompetent, and their personal experience revealed that the impact of decentralisation and an inadequate judicial system were the two primary deterrents to doing business in post-crisis Indonesia. Other interviews comprised of informal conversations at various business events, particularly those staged by the Indonesia Australia Business Council (IABC) and the British Chamber of Commerce Indonesia (BritCham). Fieldwork also included observations of a number of meetings, presentations and speeches in Jakarta, including a meeting between President Susilo Bambang Yudhoyono (SBY) and the foreign investment community. These fieldwork activities served to lend significant support to the central arguments of the thesis in regard to the relationship between the foreign investment community, the Indonesian government, the nature of corruption in Indonesia, and the impact of the IMF’s SAP. In particular the interviews served to support the empirical evidence and academic literature that was surveyed for this thesis. Thus the information acquired on fieldwork supports the conclusions that:

- the IMF requires an extensive organisational reform and revision of its programs;

\textsuperscript{11} R. Ramli, Interview, Jakarta, September 2005.
\textsuperscript{12} Foreign Businessperson, Interview, Jakarta, August 2005.
• the application of neo-liberal economic policies in a developing state does not necessarily benefit the economy; and

• a decentralised system of governance may not reduce corruption levels; rather it may alter the way in which corruption functions. Corruption that operates in a fragmented manner creates high levels of uncertainty and is thus not conducive to foreign direct investment.

The empirical evidence gathered through databases and the qualitative primary evidence from fieldwork in Indonesia has been integrated into and discussed, chapter by chapter, in the context of the scholarly literature relevant to the various topics covered in the thesis.

1.4 Chapter Structure

This thesis addresses the arguments above in the following manner. Chapter Two contextualises the IMF’s explanation of and approach towards the East Asian economies. It first explores how the institution explained the region’s high growth rates during the 1980s and early 1990s, and conversely, the basis upon which it identified the causes of, and remedy for, the Asian crisis. It argues that as Washington-based institutions, the IMF and World Bank became the international institutions that promoted and represented neo-liberal ideology. The second part of Chapter Two reviews arguments about the role of the state in economic development. It shows the difficulty of developing a concept of a model definitive of Asian Capitalism, as the debates surrounding the factors that constitute the model and their impact on development are somewhat paradoxical. Finally it discusses the neo-liberal and hence the IMF response to the so-called Asian Model. If indeed there is a definitive ‘Asian’ variant of ‘Asian’ capitalism, then culture is apparently central to it. It argues that the ideals of Confucianism and indeed Asian Values were employed to explain state intervention in the economy, however this position perhaps unnecessarily ‘orientalises’ Asian economic development.

Chapter Three argues that presenting a definition of the term ‘corruption’ is in itself not possible unless it is first conceded that its construction cannot be free of political and cultural bias. The assumption that corruption is exclusively a problem of
development has been increasingly challenged by authors sceptical about the evidence behind the cultural argument. Solutions of any merit to the ‘problem of corruption’ are predominately recognised by western governments as outcomes of international agencies, such as the anti-corruption and good governance initiatives of the IMF and World Bank. The IMF indeed worked upon the premise that corruption was the cause of the problems in Indonesia when it formulated its crisis management program.

Chapter Four provides the historical background to understand what the IMF was dealing with during the late 1990s. This chapter thus addresses 1) how economic growth occurred under the Suharto regime, 2) how systems of pervasive corruption and economic development co-existed in Indonesia, 3) how oligarchy was fostered and consolidated under authoritarian rule, and 4) how FDI operated in Indonesia’s pre-crisis environment. It covers the period from independence through Guided Democracy to the consolidation of New Order government and provides an insight into the rapid period of growth that was fostered by the Suharto regime, drawing comparisons with the economies of Malaysia, Thailand and South Korea, charting the pattern of shift from strategies of Import Substitution Industrialisation (ISI) to later Export Oriented Industrialisation (EOI). The states in East Asia were considered proverbially ‘strong states’, where governments had adequate authority to ‘steer’ the economy. But this approach involved heavy government intervention in the economy whereby a ‘picking winners’ strategy was often employed. Empirical evidence documents Indonesia’s history of economic growth, which makes it clear that it was genuine growth that occurred alongside and despite the prevalence of entrenched and controlled corruption. Indonesia’s system of governance was based upon patronage networks and oligarchy. Indonesia’s ‘opening up’ to the international market in the 1980s did allow for the entry of foreign capital, but the conditions under which that capital was to operate, and other regulations placed on the economy, such as import/export tariffs, remained stringent.

Chapter Five details the specificities of the IMF’s program in Indonesia and the political interplay between the Indonesian government and the IMF. It argues the essential shortcoming of the IMF’s mission to Indonesia was the assumptions that lay behind the institution’s strategies and prescriptions. While a lot of evidence exists that suggests that the Fund’s operations in Indonesia were at best problematic and at worst a
disaster, it is still necessary to provide an account and assessment of the program within this thesis. The IMF’s intervention in September 1997, shortly after the crisis initially struck, failed to stem the continued depreciation of the rupiah, economic deterioration and seemingly unstoppable outflow of capital. The market response to the events that unfolded was accordingly panicked. The Fund’s incompetence is evident from the outset of the program, showing that an intimate knowledge of the Indonesian economy was notably lacking. It argues that the Fund’s attempt to transform Indonesia’s economy so that it would operate on a more ‘liberal’ or ‘open’ basis was both overly ambitious, and the agenda behind the program is open to criticism. However, the ramifications of the program were not exclusively economic, but also social. The austerity measures saw a dramatic increase in poverty levels, which remained relatively high as the economy continued to contract. This claim is demonstrated by the fact that Indonesia did not recover as quickly as Malaysia, South Korea and Thailand, and is only now, ten years later, beginning to attract significant levels of FDI.

Chapter Six analyses the domestic political and economic effects of the IMF’s package. It presents a discussion and analysis of the impact of the IMF programs during the post-Suharto era up until the end of the Megawati presidency in 2004 by examining conflicts associated with Indonesian political parties, the Angkatan Bersenjata Republik Indonesia (ABRI or the Armed Forces of the Republic of Indonesia) now Tentara Nasional Indonesia (TNI or the Armed Forces of Indonesia) and social groups in their struggle for power or redefinition of roles in the new democratic environment. In particular, the chapter addresses the impact of reform upon politico-business interests in Indonesia, and finds that the IMF’s attempt to diffuse oligarchic power largely failed. While new actors also emerged, the major politico-business groups remained intact under the Presidencies of BJ Habibie (21 May 1998 – 20 October 1999), Aburahman Wahid (20 October 1999 – 23 July 2001) and Megawati Sukarnoputri (23 July 2001 – 20 October 2004). This can in part be attributed to decentralisation, whereby the central government’s power was undermined by the provincial, district and regional governments to the point where the vested interests quickly re-located their networks. Subsequently, the so-called regional ‘mini kingdoms’ that evolved as a result of decentralisation fostered a system where corruption still prevailed, yet certainty of achieving paid-for results having handed over money did not. This was the biggest
impediment to FDI, which was extensive under the certainty of the Suharto regime, but which contracted in a new climate of uncertainty.

Chapter Seven provides an epilogue of post-IMF Indonesia and the different arguments that are being put forward regarding the reformation of the IMF and other International Financial Institutions (IFIs). The presidency of Susilo Bambang Yudhoyono (SBY), which commenced in late 2004, has been free of direct IMF pressure, which was ensured by the Indonesian President himself when he repaid the outstanding IMF debt early. While the aim is not for the SBY government to return to the New Order style of politics, re-regulation of government power has created a climate which is better for foreign investment as a degree of certainty has been re-established. To this extent the experience of Indonesia dovetails with calls to reform the world’s major international institutions, particularly the IMF, which lies at the centre of the debate over the appropriateness on neo-liberal economic measures for developing economies.

Chapter Eight reflects on the practice of external intervention, the mistakes of the IMF and the future of state intervention in domestic economies under the prevailing conditions of free trade and globalisation. The argument here, based on a detailed examination of the assumptions, implementation and outcomes of the IMF program for Indonesia, is that the central tenets of the neo-liberal ideology, upon which the IMF’s programs are based, are fundamentally flawed. Free market economics does not necessarily promote equitable economic growth and indeed the survival of both domestic economies and the international financial architecture is reliant upon state intervention. This is evidenced in the case of Indonesia where free market reform failed to restore economic growth. However, the Indonesian example is not exclusive as can be seen in more recent cases such as the subprime lending crisis where the global financial system was propped up by the US Federal Reserve and other central banks. In the specific case of Indonesia, the IMF’s reforms placed excessive emphasis on corruption as the main cause of the crisis whilst virtually ignoring the impact of external financial economic volatility. Instead, the IMF program promoted the opening of markets in Indonesia and restricting the government’s capacity to regulate the economy, a strategy that rendered the country even more susceptible to the whim of international
capital flows. The measures enacted created conditions of high uncertainty due to the political, social and economic reaction to IMF reform in Indonesia and this subsequently served to deter rather than attract FDI. A decade later the effects of the IMF’s misdiagnosis and mismanagement of Indonesia’s economic woes linger still, a legacy of the Fund’s war on corruption.

This thesis concludes that the IMF’s Indonesia program failed, as economic growth and levels of foreign direct investment were not rehabilitated. Rather, they were inhibited. The IMF’s Indonesia program over-stepped its mandate in regards to its meddling in domestic politics, and placed inappropriate and unrealistic demands on the Indonesian government. The conclusion argues that there are still lessons to be learned by the neo-liberal project from the East Asian crisis, namely that:

- democratisation is a process, and cannot be achieved instantaneously by simply altering the political structure of a state;
- there is a case to be made for the validity of quasi-regulatory states as a means to economic development;
- the state can play a role in preventing or at least reducing the impact of a financial crisis;
- neither national economies nor the international financial system are insulated from vested interests; and
- the so-called free market system is dependent upon state intervention to prevent collapse.