The IMF's Indonesian Myths

Dr. Rizal Ramli

In a widely-quoted article published in early October 1997 I argued that involving the IMF in Indonesia's recovery program would inevitably plunge the country into a deeper economic crisis. On the basis of the institution's past performance, I felt that it was more likely that the IMF would act as surgeon rather than savior, severing limbs from the Indonesian economy and sending the country a large bill for its services. The IMF's success rate in operations of this sort is less than 30 percent, and many patients have experienced a temporary recovery followed by a catastrophic relapse and the need for additional surgery. Numerous examples from Latin America and Africa had shown that the institution's generic diagnosis and treatment has failed to cure the patient. At the moment, for example, Argentina—a patient of the IMF since the 1970s—is facing another economic crisis and will likely default on its US$130 billion debt.

The act of calling in the IMF in 1997 only served to deepen the economic crisis, already the most serious in Indonesia's history. There is no doubt that the crisis is the result of internal factors, and the solution demands tougher internal measures than have yet been contemplated. But the IMF's misdiagnosis and subsequent policy errors transformed the crisis into an economic disaster of previously unimaginable proportions.

Many domestic observers question the intentions of the IMF in Indonesia, and there is certainly no shortage of conspiracy theories to explain the institution's poor performance since 1997. My own experience suggests that the IMF is in fact well-intentioned, but constrained by its adherence to a demonstrably erroneous diagnosis of Indonesia's economic problems and the institution's misplaced faith in orthodox policy prescriptions. Many American scholars and politicians agree with this conclusion. For example, Steve Forbes, publisher of Forbes magazine, argues that IMF-inspired policies of monetary contraction and tax increases worked to intensify economic crises in Mexico, Argentina, Thailand and Indonesia.

The U.S. Congress formed a commission chaired by Professor Alan Meltzer of Carnegie Mellon University to evaluate the IMF's performance. The commission sharply criticized the IMF for its ineffectiveness and recommended thoroughgoing reform of the institution. Professor John B. Taylor of Stanford University goes further, arguing that IMF should be closed down.

Previously, former World Bank Chief Economist and Nobel prize winner Professor Joseph Stiglitz accused the IMF of exacerbating the East Asia financial crisis. Stiglitz criticized the IMF for pursuing failed economic policies despite overwhelming evidence of the ineffectiveness of these policies, and for the unprofessional behavior of IMF economists as the crisis unfolded.

The IMF Prescription: Three Stages of Disaster

The IMF's role in Indonesia has passed through three stages since 1997. *In the first stage*, the IMF's super-tight monetary policy worked to aggravate instability in the financial markets. The inter-bank interest rate rocketed from 20 to 300 percent from the third quarter of 1997, creating a liquidity crunch in the banking sector as banks found it impossible to obtain short-term credits to cover their immediate obligations. Then in November 1997 the IMF then recommended the closure 16 banks despite grossly inadequate preparation, resulting in a general run on domestic banks. This was followed by a capital outflow of about US$5 billion that placed further pressure on the rupiah. As a result, Indonesian businesses were subjected to the twin blows of soaring interest rates and a sharply devalued currency. The inevitable consequence of these policies was mass bankruptcy in the corporate sector and the loss of thousands of jobs. In 1998 the economy contracted by 13 percent, the worst performance in the nation's history.

In the second stage, Indonesia's private debt was converted into public debt. Whereas prior to the crisis Indonesia had no domestic public sector debt, under IMF policies the government's domestic debt swelled to US$65 billion. Meanwhile, the public sector international debt rose from US$54 to $74 billion while international private debt decreased from US$82 to $67 billion due to accelerated repayments and restructuring.

Indonesia's debt is now larger than gross domestic product, which stands at US$150 billion. As a consequence of the financial crisis and IMF policies, Indonesia's debt has doubled over a period of just four years.

In the third stage, IMF policies have put unsustainable pressure on the government budget. For the 2002 fiscal year, debt servicing is estimated to total US$13 billion (Rp 130 trillion) including domestic and international payments. These payments amount to more than three times the total public sector wage bill including the military, and eight times the education budget. The size of the domestic debt is closely related to Bank Indonesia's tight money policy. Under the guidance of the IMF, Bank Indonesia has pursued an anti-inflation policy based on increasing the interest rate on its securities (SBI). Yet most of the increase in the inflation rate is a direct result of government price increases rather than monetary factors. The main effect of Bank Indonesia's tight money policy is to increase the fiscal deficit. Every one percent increase in the SBI rate widens the government deficit by Rp2.3 trillion.

Bank Indonesia is also responsible for the misallocation of Rp. 144 trillion in liquidity credits (BLBI) during the early stages of the financial crisis. This scandal alone has imposed a financial burden on the Indonesian people of historic proportions.

The growing debt burden and resulting fiscal deficit will force the government to raise taxes, electricity rates and fuel prices and to sell off state assets at fire-sale prices. The case of Bank Central Asia is an interesting example. The target price of Rp5 trillion does not take into account the cost of the bank's recapitalization, estimated at between Rp.7 and 8 billion. Even after the sale of BCA the government would continue to service this debt unless these costs are included in the deal.

In short, IMF policies, have created a debt trap from which there is no escape. The IMF has forced Indonesia to accept its misdiagnosis and failed prescriptions, including the transfer of private debt to the public sector.

In 1999 The IMF admitted its errors in Indonesia in its internal reports. Tragically, the patient had already fallen into a coma, and the doctor apparently does not carry malpractice insurance.

Four IMF Myths

The are four myths concerning the IMF's role in Indonesia to justify continued deference to the institution. **The first myth** is that the presence of an IMF agreement increases investor confidence in Indonesia. Yet after numerous Letters of Intent and four years under IMF supervision, investors have yet to demonstrate a renewed faith in Indonesia. The main problems are of course continued political instability, political and communal violence and the absence of rule of law. If these problems could be resolved the IMF would add nothing in terms of restoring the confidence of the business community.

The second myth is that IMF lending is accompanied by an increase in private sector capital flows. But in fact the reverse has occurred in Indonesia. The past four years have seen a *decoupling* of multilateral lending from private lending as commercial banks have systematically reduced their exposure in Indonesia. Again, political instability, violence and the weaknesses of the legal system are to blame.

The third myth is that the IMF's presence will strengthen the rupiah. By now this can only be regarded as a bad joke. Since October 1997 every IMF superivision mission has been accompanied by a weakening of the rupiah, and on every occasion Bank Indonesia has been forced to intervene to stabilize the currency markets. In general, the relationship between the IMF and the value of the rupiah is assymetrical. When IMF officials make positive statements about the Indonesian economy the currency does not strengthen; but when they criticize the government the rupiah weakens.

The fourth myth is that the IMF conspires with other creditors to restrict lending to countries that are not under IMF supervision. This is not the case, as each creditor has its own strategic interests in Indonesia, and often do not agree with one another. As Co-ordinating Minister of the Economy, I signed loan agreements with the World Bank, the government of Japan and the Asian Development Bank despite our disagreements with the IMF. Indeed, other creditors view the IMF as obstinate and inconsistent, often imposing rolling conditionalities—in other words, moving the goalposts—on borrower governments. Other multilateral agencies are aware that withholding new credits to Indonesia would only result in cashflow problems leading to increasing risk of default, which is not in their interests.

These myths have been repeated *ad nauseum* to convince the public that the IMF is the only thing standing between Indonesia and economic anarchy. Yet the evidence from other countries in the region suggests the opposite: Malaysia endured the financial crisis without IMF intervention, and the Taksin government's decision to suspend its IMF agreement has had little of no impact on the Thai economy. It should also be noted that Thailand's decision to discontinue its IMF program in no way implies that the country is no longer a member of the IMF.

In fact, for some time now IMF credits are also unnecessary in Indonesia. Because IMF borrowing is a *second tier defense*, the US$400 million in question represents an addition to Indonesia's reserves that would only be used if Indonesia were to run out of foreign exchange. Yet at the moment the country has US$28 billion in reserves, and Indonesia's flexible exchange rate policy ensure that downward adjustment of the currency prevents depletion of foreign currency reserves. In other words, the IMF credits cannot be used, but Indonesia must still service this debt. For fiscal year 2001, for example, Indonesia received only US$400 million in IMF loans while paying US$2.3 billion to the IMF consisting of US$1.8 billion in repayments of principal and interest payments of US$500 million. Although guilty of gross malpractice, the doctor still demands the payment of fees and interest on the patient's debt.

In a recent interview published in Business Week (19 November 2001), Joseph Stiglitz has remarked that IMF programs lasting more than two years are evidence of the failure of the IMF. The IMF, according to Stiglitz, "imposes too many conditions, some of which are political, many of which get into microeconomics, well beyond the area of its mandate and competence."

It is now time for a comprehensive evaluation of the costs and benefits of the IMF program in Indonesia. Serious debate in parliament and involving the general public of the role of the IMF is urgently needed if we are not to repeat the mistakes of the past four years.