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ERD Working Paper

ECONOMICS AND RESEARCH DEPARTMENT

SERIES

No. 76

Policy Reform in Indonesia
and the Asian Development
Bank's Financial Sector Governance
Reforms Program Loan

George Abonyi

December 2005

Asian Development Bank

ERD Working Paper No. 76

**POLITICAL ECONOMY OF REFORM: CASE STUDIES OF ASIAN DEVELOPMENT BANK-
SUPPORTED POLICY-BASED LENDING OPERATIONS**

**POLICY REFORM IN INDONESIA AND THE ASIAN
DEVELOPMENT BANK'S FINANCIAL SECTOR
GOVERNANCE REFORMS PROGRAM LOAN**

GEORGE ABONYI

December 2005

George Abonyi is Executive Director, Asia Strategy Forum and Associate Senior Fellow, Institute of Southeast Asian Studies. This work was undertaken as a consulting assignment with the Economics and Research Department (ERD), with Xianbin Yao, former Assistant Chief Economist, and Richard Bolt, former Senior Economist, ERD, providing overall guidance. It builds on earlier work for ERD initiated under the direction of David Edwards, former Assistant Chief Economist; and also links closely to related work undertaken by ERD and published in June 2003 by the Asian Development Bank as the Economic Analysis of Policy-Based Operations: Key Dimensions. The analytic framework for policy reform presented in the paper was influenced by earlier collaboration with John Thomas (Harvard University). The views and opinions expressed in the paper are those of the author.

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FOREWORD

The ERD Working Paper Series is a forum for ongoing and recently completed research and policy studies undertaken in the Asian Development Bank or on its behalf. The Series is a quick-disseminating, informal publication meant to stimulate discussion and elicit feedback. Papers published under this Series could subsequently be revised for publication as articles in professional journals or chapters in books.

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
ASPL	Agricultural Sector Program Loan
BI	Bank Indonesia
BLBI	Bank Indonesia Liquidity Assistance
CAMEL	capital, asset, management, equity, and liquidity
CAR	capital–asset ratio
DFID	Department for International Development
IBRA	Indonesia Banking Restructuring Agency
IFIs	international financial institution
IMF	International Monetary Fund
INDRA	Indonesia Debt Restructuring Agency
LOI	Letter of Intent
MOF	Ministry of Finance
NPLs	nonperforming loans
OJK	Otoritas Jasa Keuangan (Financial Service Authority)
SMEs	small and medium enterprises
SMF	Secondary Mortgage Facility
SOE	state-owned enterprises
WB	World Bank

ABSTRACT

This paper presents a case study of the Asian Development Bank's Financial Sector Governance Reforms Development Program Loan (the Program) to the Government of Indonesia. The case study focuses on the political economy dimension of policy reform and its implications, rather than on Program details. Launched in June 1998, the Program was part of a multi-donor effort led by the International Monetary Fund, to help Indonesia respond to the Asian economic crisis and undertake reforms in the financial sector. The design and implementation of the Program took place in an environment characterized by an unexpected, deep, and sustained economic crisis, accompanied by social instability, and political and institutional uncertainty and change. Against this backdrop, the case study examines the context of Indonesia's policy reforms in the financial sector and the general design of the Program. It touches on the implementation of selected reforms and sustainability of the reform process. The purpose is to draw lessons that can assist in the more effective preparation and implementation of such reforms, and design of policy-based lending. In order to help structure the case study, a framework is introduced for the analysis of the political economy dimension of policy reform. This framework is proposed as a useful general tool both for the *ex post* understanding of the political economy dimension of policy reform, as well as an analytic tool for assisting in the *ex ante* design of specific policy reform programs and related policy-based lending.

“In order to learn how men will act in a given situation, or how a change in the situation will modify their behaviour, it is surely more practical to observe their behaviour than to attempt to discover by introspection or otherwise what they might be supposed to do if actuated by a certain motive operating alone.... Of much greater importance to the economist than any ‘pure’ theory are the knowledge and understanding of the concrete facts of production, distribution, consumption, of the whole economic situation with all its causal processes. To most of this material the processes of specific observation, systematization, and inductive inference are applicable. To much of it, particularly in its dynamic processes, or processes of change, no other method is of any service.”

Jacob Viner (1917)

FOREWORD TO THE CASE STUDIES

A. Research Strategy

This research focuses on exploring the political economy dimension of policy reform. The *research strategy* involves developing a set of comprehensive *case studies* of policy-based lending programs supported by the Asian Development Bank (ADB) in three countries: Indonesia, Thailand, and Viet Nam. This paper focuses on Indonesia.

The case studies were designed to present detailed stories about the policy reform process, focusing on the political economy dimension of reforms. The aim of each case study is to provide not only an account of a particular ADB program, but more important, to place it in the specific—and evolving—reform context in which the program was formulated and implemented, describing the policy process involved. Since the context is so crucial with respect to policy reform initiatives, the case studies provide stories or narratives on local conditions and historical circumstances. The focus of the cases is on the *interplay* between ADB’s program and surrounding environment, with particular emphasis on the policy reform process and its political economy dimension. The basic purpose of the case studies is to find out why and how things happened, so that this knowledge can be used to better understand the policy reform process, in particular the role of political economy factors; and more specifically, to assist in the future planning and implementation of programs supporting policy reforms.

The *general preparation for the case studies* has involved an extensive *literature review* focusing on policy reform and the policy/reform process, with particular emphasis on the political and institutional dimensions. Examples of the literature reviewed include Grindle (2001), Grindle and Thomas (1991), Drazen (2000), Brinkerhoff and Crosby (2002), Haggard and Kaufman (1992),

and Bates and Krueger (1993), as well as a variety of related case studies. A second part of the preparation for the conduct of case studies involved the *development of a framework* for understanding/representing the political economy dimension of policy reform. A preliminary framework, drawing on both literature review and in-depth examination of a variety of cases/examples in diverse settings, is presented in Abonyi (2002). The preliminary framework discussed in that paper was further refined prior to the case studies, including through training workshops; and is then tested through application to this set of case studies.

B. The Case Study

Case studies have been an accepted part of research and teaching in a wide range of disciplines, including law, medicine, management, as well as public administration and public policy. There is an extensive and growing literature focusing on the case study method, e.g., Yin (1994), Flyvbjerg (2004), Helper (2000), and Odell (2001); as well as many cases and related research manuals prepared in top management and public administration/public policy schools. However, the use of the case study is relatively rare in economics as a research strategy. The issues raised in the earlier quote from Viner (1917) are equally relevant today, and as Helper (2000) notes:

Modern economics began with Adam Smith's visit to a pin factory, which helped him explain how the division of labour worked.... However, not many economists today do much fieldwork, which involves interviews with economic actors and visits to places they live and work.

What counts as a case can be as flexible as the researcher's definition of the subject. In general, a *case* from a research perspective refers to a single instance of an event or phenomenon, such as a decision to devalue a currency, a trade negotiation, or in the particular instance here, a specific policy-based lending program of ADB involving a set of reform measures.

A comprehensive case study can make an important contribution to the understanding of a complex issue such as policy reform. It allows for concrete, context-dependent learning and the presentation of a detailed and nuanced view of the world that approximates the complexities and contradictions of the reality of the reform process. Case studies complement other types of economic research such as theoretical, mathematical, statistical, and econometric inquiry. In general, the benefits of case studies include the following:

- (i) A case study conveys a much fuller understanding of the particular concrete event and behavior studied—including richer evidence and reasoning about process and context—than is possible through more abstract methods.
- (ii) Complex processes may be most effectively documented through case studies. The world of economics is marked by significant processes like market evolution, competition, bargaining, institutional change, regional integration, and policy reform.
- (iii) Institutional and structural change can perhaps best be understood through case studies. For example, reforms involving introduction of market-based mechanisms into once centrally managed economies involve changes in institutions over time. Documenting such changes is the first step toward deeper analysis and generalization.

Preparing comprehensive case studies takes a great deal of time and effort. It requires going into extensive details on the event and its context in order to construct the “narrative” that captures the complexity and nuances of the real life situation. In particular, preparation of the case studies presented here has involved the following steps:

- (i) Review of key documents related to the “event”, i.e., the ADB policy-based program, including relevant ADB documents, accessible documents of other international financial institutions (IFIs) such as the International Monetary Fund (IMF) and World Bank, and to the extent available, documents of the government (in this case, of Indonesia).
- (ii) Review of literature, analysis, and data on the specific policy reform context, for example, as related to Indonesia’s financial sector, nature, and impact of the Asian crisis on Indonesia particularly on its financial and corporate sectors, political context, policy reform process, and on how it evolved through political and institutional changes.
- (iii) Extensive interviews with key participants, including government officials involved with the policy reform process in general, and in particular those involved with the design, negotiation, and implementation of the specific ADB program; ADB staff and management; and staff of other relevant IFIs
- (iv) Application of the analytic framework to structure the information, and in the process, testing/refining the framework through the cases.

In summary, the case studies here are intended to generate (i) *individual detailed stories* or analyses that provide information about the policy reform process in a particular setting; (ii) a *set of stories/analyses* that can provide the basis for generalizations about policy reform; and (iii) a *framework* that has been tested and refined through application, and that may be used to guide future analysis, including for a better understanding of experience (*ex post* assessment) and in the design of more effective programs to support policy reform (*ex ante* analysis).

I. INTRODUCTION

A. Prologue

On 5 July 2002, the \$1.4 billion Financial Sector Governance Reforms Development Program Loan (the Program) provided by the Asian Development Bank (ADB) to support the Government of Indonesia’s policy reforms in the financial sector was officially closed. With the initial disbursement back in June 1998, the Program took a while longer than expected. In fact the implementation of this, the second largest loan ever provided by ADB, was delayed well beyond the original planned closing date of 31 December 1999. The delay was predominantly due to political economy factors: significant political and institutional constraints, uncertainty, and change—triggered by an economic crisis of unprecedented proportions.

The Program was part of an effort led by the IMF and other IFIs, namely, ADB and World Bank to help the Government of Indonesia respond to the Asian economic crisis, and undertake related policy reforms. The design and implementation of the Program therefore took place in an environment characterized by an unexpected, deep, and sustained economic crisis, accompanied

by social instability, and political and institutional uncertainty and change. There were rapid changes in the government at the political and policy-making levels, including a succession of four presidents from Program design through implementation. More fundamentally, this period saw a transition from a highly centralized political and policy decision system with a powerful and dominant president who held power for 32 years, to a more pluralistic, diffused, and evolving system with an increasingly active Parliament. This was accompanied by basic transformations and uncertainty in the institutional environment of the financial sector, which conditioned policy reforms and Program implementation.

Yet, given that its design and implementation took place under such turbulent conditions, the Program to a large extent has stood the test of time and events. The issues identified were for the most part those that continue to be relevant to the Indonesian economy; and the Program made important contributions both to the country's crisis recovery and to key longer-term reforms. Still, at the closing of the loan, the likelihood of the real implementation and sustainability of key reforms remained uncertain, and the financial sector remained fragile.

This paper presents a case study of ADB's Financial Governance Reforms Sector Development Program Loan that was aimed at supporting fundamental reforms in Indonesia's financial sector. The purpose is to draw lessons that can assist in the more effective preparation and implementation of such reforms, and in particular, policy-based lending.¹ In order to help structure the case study, a framework is introduced for the analysis of the political economy dimension of policy reform. This framework is proposed as a useful tool both for *ex post* understanding of the political economy dimension of policy reform (as in the case of the Thai Agricultural Sector Program Loan [ASPL]; see Abonyi 2005a), as well as an analytic tool for assisting in the *ex ante* design of specific policy reform programs and related policy-based lending.

B. Policy Reform: Political Economy Perspective²

Policy reforms and policy-based lending supporting such reforms are often not implemented as planned, or may lead to unexpected and at times undesirable consequences. Recurring problems associated with policy reform—and supporting policy-based lending—arise because such reform is fundamentally not a technical exercise in “optimal policy design”, but a complicated, long-term, and uncertain process of change in incentives, behaviors, institutions, relationships, and power alignments.³

The reform process takes place in an environment where “political economy” factors play a critical role in shaping policy reforms, and in conditioning the effectiveness of related policy-based lending.⁴ At the most general level, the term “political economy” refers to the interrelationship between political and economic processes and institutions, of particular interest here as related to policy decisions and reforms. A “political economy” perspective signals the central role of politics and institutions in the policy reform process. Reform involves politics, because it requires making

¹ For example an accompanying teaching case has also been prepared for the Thai case (see Abonyi 2005a).

² This section is based on Abonyi (2002).

³ For a more detailed discussion of policy reform as a process of change see Abonyi (2002).

⁴ For detailed discussion of this issue see Abonyi (2002).

collective choices in an environment characterized by conflicting perceptions and interests, with no simple unifying incentive scheme for resolving such differences.⁵ Policy reform also takes place in a world of institutions that condition the initiation, design, and implementation of such reforms.⁶

The role that politics and institutions play in policy reform and associated programs (e.g., the Program) is related to how such policies and programs are shaped as they move through the various stages of the policy reform process. These stages, which in practice tend generally to be more iterative than sequential, and not particularly well defined but nonetheless identifiable, include the following:⁷

- (i) *Initiating reform*: How did the basic issues addressed by the Program get on the policy agenda as political priorities, especially in the midst of a deepening economic crisis when many other issues are increasingly competing for scarce policy attention and resources?
- (ii) *Managing the complexity of policy issues*: Policy issues are complex; therefore the *design* of the Program, in particular the policy matrix, is a way of reducing this complexity so that policymakers and implementing agencies can act on such issues. In this context, how well does the design of the Program “map into” the policy issues?
- (iii) *Endorsing reform*: Reforms need to be legitimized—endorsed or approved—through a process of policy-related decision making. However, in practice, it is often not clear when or even where in the policy process such decisions are actually made in a way that signals the government’s binding commitment to reforms. This is particularly the case when there are key and successive changes in the government, and more fundamentally, in the very nature of the political and policy decision system, as in Indonesia during the Program.
- (iv) *Implementation*: Implementation involves institutions (e.g., Bank Indonesia or BI) and stakeholders (e.g., banks) translating proposed reforms into actions that lead to changes in incentives, resource flows, behavior, relationships, institutions, and power alignments. However, as reflected in the case, in practice the meaning of “implementation” may be ambiguous.
- (v) *Sustaining reform*: Policy reform requires a long-term and enduring process of change. In the case of the Program, the challenges of sustainability relate to both the specific reform measures in the policy matrix, and to more general enabling factors that condition the sustainability of such reforms.

The stages of the policy reform process, their relationship to the role of politics and institutions in policy reform, and how these core political economy factors constitute key sources of uncertainty and risk in reform (such as in government commitment) together comprise a

⁵ This is consistent with Drazen (2000); see also Abonyi (1986).

⁶ For a discussion of the role of institutions in policy reform see Rodrik (2003). At the micro level, reform is implemented by institutions and involves organizational change. The management literature is suggestive here; see for example Smith (2002).

⁷ This is based, in part, on Grindle and Thomas (1991). See Abonyi (2005a) for a more detailed discussion of these stages in the context of ADB’s Agricultural Sector Program Loan to Thailand. See also Abonyi (2005b) for a discussion in the context of ADB’s Financial Sector Governance Reforms Program Loan to Indonesia.

conceptual framework for assessing the political economy dimension of reform.⁸ The framework is summarized in Figure 1, and serves as the organizing framework for the case. It is proposed as generally applicable to a wide variety of reforms in diverse settings: providing a useful framework for the analysis of particular cases of policy reform such as the Program. However, the application of the framework—both as an *ex post* tool for understanding the political economy dimension of policy reform, and as an *ex ante* analytic tool to assist in the design of specific policy reform programs and related policy-based lending—must proceed from a detailed and comprehensive understanding of the *specific context* of policy reform programs. For example, analysis of the Program must begin with a basic understanding—and therefore an extended discussion—of key issues in Indonesia's financial sector, as well as of the onset of the Asian crisis and initial responses to it. This defines the context that shapes the evolution of the Program.

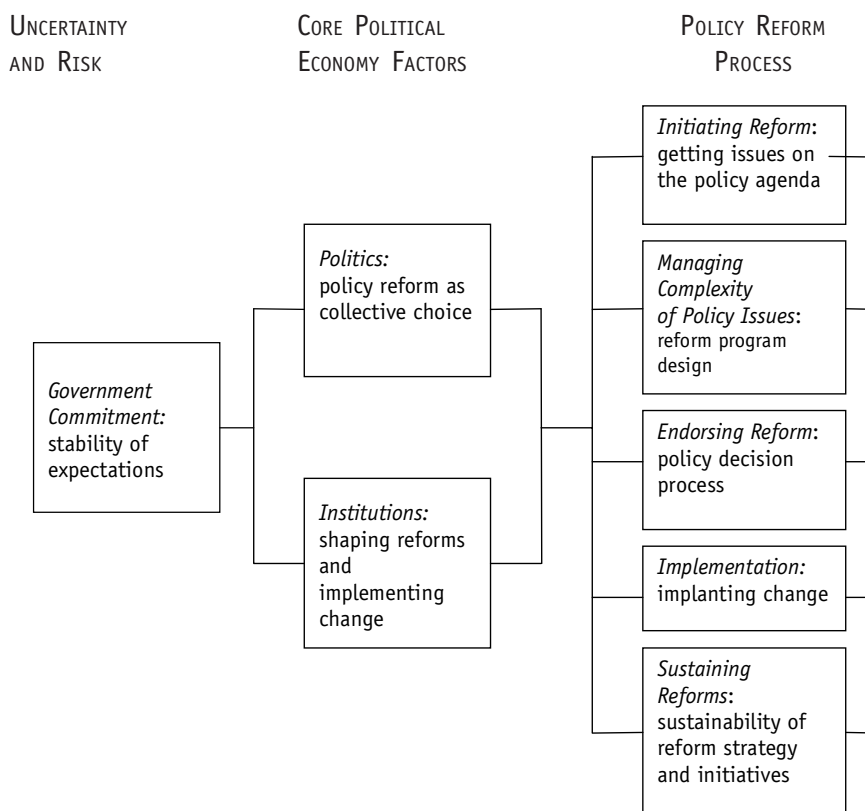
The rest of this paper is structured as follows. The next section (II), presents the context of the Program. It begins with a brief discussion of the onset of the crisis in Indonesia, followed by an overview of weaknesses in the financial/banking sector prior to the crisis. Section III discusses the Program as part of the IMF-led IFI package of support to the government in the context of a framework that incorporates key stages of the policy reform process: (i) initiating reform or getting issues on the policy agenda, making complex policy issues manageable through program design, endorsing reform via the policy decision process, implementation aimed at implanting reforms, and sustaining reforms; including (ii) sustaining the overall reform strategy and core reform initiatives. Building on this, Section IV presents a discussion of the nature and role of politics and institutions in policy reform, as reflected in the case, including their implications for “government commitment” with respect to policy-based lending. The final section (V) summarizes key lessons learned from the case, and makes some general observations about the implications for policy-based lending and associated conditionalities.

In sum, it is politics and institutions that are key sources of recurring complications—of uncertainty and risk—in policy reform and policy-based lending. This is clearly reflected in the case of the Program, where political and institutional factors emerged as key constraints on sustained policy reform in the financial sector. Therefore a better awareness of the role of these political economy factors, within the framework of the policy reform process, may help reduce the gap between the planned and actual outcomes of reforms. Hopefully this will lead to a better awareness of the likely risks and uncertainties of reform programs and associated policy-based lending, which in turn will strengthen their design and implementation.⁹

⁸ The framework draws on a range of developments in the literature, particularly Grindle and Thomas (1991), as well as Haggard and Kaufman (1992), Brinkerhoff and Crosby (2002), Drazen (2002), and Abonyi (1986).

⁹ “Effective” refers here to reforms that are both relevant and feasible; see Abonyi (2002).

FIGURE 1
POLITICAL ECONOMY OF POLICY REFORM AND POLICY-BASED LENDING:
A FRAMEWORK



II. SETTING THE STAGE FOR POLICY REFORM

A. Enter the Crisis¹⁰

The Program was part of an IMF-led response by the IFIs to what began in 1997 as a deep and unprecedented “financial” or “banking crisis” in Asia (the crisis); which then evolved into an “economic crisis”; and led to social upheaval, and fundamental political and institutional changes. The general literature on the crisis in Indonesia and on the role of the IFIs is extensive: for a general discussion, see for example O’Rourke (2002) and Schwarz (1999); for more technical

¹⁰ See Kenward (2002) for an excellent and detailed discussion of the onset of the crisis in Indonesia, on which much of this section is based.

discussions, see for example Boediono (2002), Boorman and Hume (2003), Enoch et al. (2001), IMF (2003), Kenward (2002a), Pangestu (2003), and Sri Mulyani Indrawati (2002). The country was profoundly transformed, a process that is still under way more than seven years after the onset of the crisis. Yet all this was far from clear in August 1997 when the regional crisis ignited by the devaluation of the Thai baht on 2 July 1997 began to impact on Indonesia.

The crisis began to be felt in Indonesia with the extensive shorting of the rupiah by foreign exchange traders in early August. There was increasing market sentiment that Bank Indonesia would not be able to sustain its existing exchange rate arrangements. However, in a move whose timing took most observers by surprise, the government floated the rupiah on 14 August 1997. To support the currency, the Minister of Finance simultaneously ordered that Rp 3.4 trillion, equivalent to about 10% base money, of state enterprise deposits be transferred from the commercial banking system to BI in the form of short-term money market instruments (SBIs). This caused short-term interest rates to climb steeply, with the benchmark 3-month swap rate exceeding 55% on 25 August.¹¹

The financial markets were unconvinced, and the downward pressure on the now freely floating rupiah compelled Indonesian corporates to scramble for dollars to repay significant and mostly unhedged foreign currency borrowings. As a consequence, by late August the stress on the banking system was becoming increasingly evident, as banks were desperate for liquidity and both corporates and banks were rushing to cover foreign exchange rate exposures. Pressure was building on the banking system as rumors of deposit runs, foreign exchange losses, and lines of credit running out were circulating, sending shockwaves throughout the economy. The rupiah continued to sink, as efforts of BI to shore up the currency proved insufficient, which hit a low of Rp 3845 to the dollar on 6 October—as compared with Rp 2655 to the dollar the day before the float.¹² With pressure intensifying on the banking system, the currency, and the economy as a whole, the government on 8 October 1997 turned to the IMF for support—following dialogue that had been ongoing since the onset of the crisis in Thailand.

The decision to call in the IMF was unexpected. Most analysts felt that although the situation was serious, it was not yet sufficiently bad to require IMF intervention. And there was also a historical “allergy” to IMF standbys in Indonesia, given the country’s experience in the late 1960s to the early 1970s. Once the decision was made, the IMF stabilization package was negotiated quickly, and the first Letter of Intent (LOI) was announced on 31 October. It was basically a standard IMF program, much like the earlier Mexican and Thai programs, composed of a core macroeconomic program, supported by some structural reforms, including a focus on financial sector restructuring, and involving reforms in the banking sector that included closing “unviable banks.”

Within the framework of the first LOI, on 1 November 1997 the Minister of Finance announced the first major reform action in the financial sector in response to the crisis: the decision to close 16 small private banks. This was seen by the government and IFIs as necessary and hopefully sufficient to address the perceived scale of the immediate problems facing the banking sector. That is, the strategy reflected in the first LOI was based on the assumption that the crisis was a moderate case of contagion with an unduly severe plunge of the rupiah in a basically sound economy, which had a generally effective economic management system in a stable political and social

¹¹ As Kenward (2002, 31) notes: “This was roughly three times the previous high, recorded during the Mexico crisis.”

¹² Unfortunately this was just the beginning, with the rupiah eventually hitting a low of Rp 17,000 to the US dollar in January 1998.

environment. Therefore it was assumed that a “traditional IMF program” of tight macroeconomic policies and limited banking reforms, supported by foreign exchange market interventions, would succeed in restoring stability, with limited and temporary impact on growth.

It was not to be. By mid-November 1997 there were clear signs that the original program failed to restore confidence, and the crisis was rapidly worsening. In particular, the closure of the 16 banks had the opposite intended effect. A measure designed to restore confidence in the banking sector resulted instead in the collapse of confidence, helping to plunge the sector into chaos. Despite the parallel announcement of a small-depositor guarantee for the 16 banks, rumors of potential bank failures circulated, leading to large runs on the deposits of banks, including the largest, Bank Central Asia. Many banks lost their deposit base. By the end of November around two thirds of the remaining private banks had experienced runs, with around Rp 2 trillion (or about \$2.7 billion) of rupiah deposits shifting to state banks, large private banks, and foreign banks; and around \$2 billion of US dollar funds leaving the banking system entirely. In general, the banks lost around 12% of their rupiah deposits, and around 20% of foreign currency deposits.

Given the failure of the closure of the 16 banks to restore investor confidence and financial sector stability, and the resulting bank runs, BI began supplying large amounts of liquidity (referred to as BLBI or Bank Indonesia Liquidity Assistance) to keep banks afloat and protect the integrity of the payment system. Besides the direct cost to BI, this rapid expansion of liquidity led to a loss of monetary control, which in turn contributed to weakening of the exchange rate and increasing distress in the corporate sector—which in turn further weakened the state of the banks.¹³ With events spiralling out of control, Indonesia entered into what is considered the most severe economic collapse suffered by a country since World War II, as the rupiah fell in January 1998 to Rp 17,000 to the dollar and the economy contracted by over 15% in 1998.

It may be useful to pause at this stage and take a closer look at the banking sector, the “eye of the storm.” Although the onset and depth of the crisis were unexpected, on closer inspection, there had been indications of problems building up in the banking sector—the core of the financial system in Indonesia (see for example Cole and Slade 1996 and 1998, Halim 2000, Kenward 2002a and 2002b, Pangestu 2003, and World Bank 1997).

B. Context: Weaknesses in the Banking Sector

1. Overview

In the years the years prior to the crisis the Indonesian financial system was transformed from a highly government-controlled sector to an increasingly market-based system. The transformation resulted from a series of seemingly erratic and often abruptly implemented financial decontrol measures.¹⁴ In this process, liberalization of the financial sector in the 1980s and 1990s

¹³ It was generally felt that given that the Indonesian banks are part of the national payments system, therefore the central bank had no option but to supply residual credit to maintain the integrity of the system, for example as contrasted with the closing of nonbank financial institutions in Thailand.

¹⁴ This is how liberalization measures are often described. However, a fundamental reason why the measures seemed erratic and inconsistent has to do with the interplay of politics and economics—the political economy of the liberalization process. See Cole and Slade (1996).

generally did not pay sufficient attention to the supervision and regulation required for a more open financial system. Neither the government nor the IFIs that supported the sector transformation appreciated sufficiently the “governance gap” that was emerging.¹⁵ This led to an effective loss of control over an exploding financial system, and was an important factor in the deep crisis that hit Indonesia in 1997/1998, where the financial sector acted “as an amplifier, not as a shock absorber, in the event of ... macroeconomic shock” (Kenward 2002).

In particular, the weaknesses related to the financial sector in general, and the banking sector in particular, revealed by the crisis included the following:

- (i) rapid expansion of the banking sector and policy inconsistencies
- (ii) overexpansion of corporate debt
- (iii) bad bank loans (nonperforming loans [NPLs])
- (iv) failure of credit assessment
- (v) weak corporate governance of banks
- (vi) inadequate supervision and monitoring
- (vii) overheating: expansion of domestic credit and financial integration

2. Rapid Expansion of Banking Sector and Policy Inconsistencies

The financial reforms of 1988 removed most of the entry barriers and various restrictions that favored certain types of banks, and introduced measures for liberalizing nonbank financial institutions.¹⁶ Within a few years of the reforms there was a dramatic increase in the number of banks and branches, money supply, and credit. For example, between 1988 and 1991 the number of new banks entering the system increased from 101 to 182, while private bank branches increased from 559 to 2,639 (Pangestu and Habir 2002). By 1994 private banks had overtaken state banks in terms of loans, deposits, and total assets; and the number of banks stood at around 240 by the time of the crisis in 1997.

Growing concern about the rapid expansion of the banking sector led to the 1991 improvements in prudential regulations. These included the introduction of comprehensive capital, asset, management, equity, and liquidity (CAMEL) quantitative rating system; requirement to meet a capital-asset ratio (CAR) of 8% risk-weighted assets by 1998; stricter information and reporting requirements; and tougher limits on lending within a corporate group or to one group. In 1992

¹⁵ For example, ADB's assistance to the liberalization of the financial system through two program loans (in 1988, 1992) did not focus on governance issues. However, it was ADB's program loan in 1998 entitled Financial Governance Reforms: Sector Development Program that introduced the term “governance” for the first time to the financial sector.

¹⁶ These measures included: (i) reduced restrictions on establishment and branching of banks; (ii) reduction of bank reserve requirements; (iii) easier procedures and active encouragement of new issues of equity securities in the capital market; (iv) clarification and simplification for establishing and operating nondeposit financial institutions (NDFIs) such as leasing, factoring, venture capital, consumer credit card companies, and securities companies; and (v) new prudential regulations for insurance industry. For detailed discussion see Cole and Slade (1996).

a new banking law passed, allowing sanctions to be imposed on bank owners, managers, and commissioners (directors) for violations of laws and regulations related to bank management; limiting the expansion of banks by increasing fivefold the capital requirements to set up domestic banks; and doubling the capital requirements to set up joint venture banks.

Despite new regulations and improvements in prudential supervision, weaknesses persisted in the legal and regulatory framework, especially with respect to loan classification and loan provisions. The number of new banks continued to increase; there was a lack of ability to enforce prudential regulations because of weak capacity and capability of BI supervisors, corruption, and political interference from bank owners close to the center of power; and related to this, violations of prudential regulations were widespread and not properly penalized.

3. Expansion of Corporate Debt

Indonesian banks were closely linked to the corporate sector: most corporations owned banks, and banks were the primary source of loans to corporations. Therefore weaknesses in the corporate sector had a direct and significant impact on the banking system. The suspect banking system, in turn, would then amplify rather than absorb macroeconomic shocks—as illustrated at the time of the crisis.

Corporations were accumulating domestic debt owed to domestic banks, often “related banks.” They were also accumulating off-shore debt in foreign currency. Domestically, many conglomerate groups circumvented banking regulations by opening their own banks as “money machines” for tapping into domestic funds. High interest and savings rates under a competitive banking system enabled these banks to access a large pool of domestic savings to finance corporate groups’ projects (increasingly in real estate) and businesses.

At the same time, accumulating foreign debt was an important source of problems in the corporate sector at the time of the crisis. By 1998 corporate foreign debt was close to US\$60 billion, approximately half the total debt of the country. This was the result of overexpansion of Indonesian corporations, which had easy access to domestic and foreign loans; overconfidence of foreign investors in providing funds to corporates arising from Indonesia’s dynamic economic development; and stability of the rupiah during the years leading up to the crisis giving corporations and investors a false sense of security so that they did not find it necessary to hedge their short-term loans. As a consequence, when the crisis hit, the rupiah plunged and interest rates skyrocketed (and the economy contracted), and corporates were unable to service their debts.¹⁷

¹⁷ As an example, Peregrine, Asia’s premier investment bank based in Hong Kong, China, lent US\$260 million—one third of its capital—in the form of an unsecured bridge loan to an Indonesian taxicab company, Steady Safe, through underwriting bonds issued by the company. Steady Safe planned to create a system of car ferries linking the islands of the Indonesian archipelago. The promissory note was made shortly after the devaluation of the Thai baht in July 1997 when the rupiah was pegged at Rp 2,500 to US\$1. Following the Indonesian currency and stock market slump, the rupiah fell to Rp 10,000 to the US\$ (January 1998), and Steady Safe was unable to repay this unhedged loan. Its stock plunged, together with the stocks of other Indonesian companies, from Rp 3,000 to only Rp 300 per share in January 1998. Peregrine was left with Indonesian stocks that no one wanted, and unable to repay its loan prior to 13 January, as its major creditor, First Chicago, could not extend the credit line. On 12 January 1998 Peregrine was liquidated. (Based on Halim 2000).

As corporate debt, both domestic and foreign, was expanding rapidly prior to the crisis, there were increasing problems of adherence to banking sector regulations. In particular, this related to the fragility of banking prudentials in terms of screening the creditworthiness of borrowing corporations, and their financial reporting. Therefore accumulation of risky corporate debts was a critical fundamental weakness of the banking sector leading up to the crisis—and whose implications were not fully appreciated in the subsequent response to the crisis.

4. Bad Debts or Nonperforming Loans

Financial liberalization indeed strengthened the competitiveness of banks and their ability to attract domestic savings. More generally, it strengthened the economy's capacity in credit and investment allocation. However, financial liberalization also created problems, which gave early signs of an impending banking crisis. One such problem was rapidly increasing volume of loans. Entry of significant numbers of new banks crowded the banking sector, and squeezed profit margins. In fighting for market share, banks increasingly accepted risky loans. Easy credit and overgenerous bank loans were the consequence of inadequate information on borrowers' financial status due to lack of transparency in accounting, and political pressure from well-connected borrowers.

Linked to these loans were rising equity and real estate prices, which were frequently used as collateral in bank loans. These prices were rapidly inflated in the growth years prior to the crisis, and this encouraged a large supply of bank credit. Credit decisions, in turn, were often made on the basis of inflated asset prices of the collateral—whether by necessity or intent—rather than risk assessment. When asset prices plunged, loans became unrecoverable, eroding the banks' capital base.

In extending credit, the ability of banks to assess creditworthiness is an important factor protecting against bad loans. However, loans were usually classified only on payment status, rather than the borrower's creditworthiness and the market value of the collateral. Therefore loan losses were understated by various means. Consequently, banks' net income and capital were overstated. This explains the diminishing capital of banks, immediately apparent after the crisis broke.

A further problem involved "footloose savings." Footloose savings arise when, given the high interest rates and low collateral requirements in Indonesia, corporate owners prefer to "invest" in savings rather than in real sectors. By doing so they could obtain interest, even as they used it as collateral for getting a loan for their business expansion. If loan applications were politically connected, or if the banks were part of the same corporate group, loans often exceeded the collateral value and the interest charges would be low. Depositors could then have the twin benefits of instant access to savings, and high interest income. In this way, big loans were obtained easily, with risks transferred to the creditor banks.

Against this background, the NPLs in the banking system increased sharply under the pressure of the crisis from around 8% in 1997 to almost 50% in 1998 (or substantially higher, by some estimates).¹⁸ As the results of subsequent independent audits of the banks showed during

¹⁸ Halim (2000) estimates that NPLs in private banks reaching 72% in 1998, from 3.3% in 1997.

the crisis, the value of loan collateral was vastly overstated. And as asset sales by the Indonesia Banking Restructuring Agency (IBRA)—established to help resolve the crisis—reflected, the real value of loan collateral for the bad loans was around 28% of their reported value, which in turn corresponds to the recovery level on bad loans.¹⁹

5. Failure of Credit Assessment

Lack of transparency in corporate financial reporting (and auditing), and in the disclosure of asset quality, made it difficult to accurately assess the actual financial position of borrowing companies—and therefore the loan portfolio of banks. Therefore while there may have been widespread doubts about asset quality of banks and corporations before the crisis, this was hard to quantify, especially when the banks were linked to corporate groups with diversified businesses, where overlapping ownerships complicated financial reporting.

Given the lack of transparency and suspect accuracy in financial reporting, it was very difficult to have a reliable assessment of the risk status of companies applying for credit. This was a critical distortion in the financial system and lay at the core of the crisis. However, more fundamentally, even if the corporations' financial status and the value of the loan collateral were known in fact to be much lower than reported, banks would generally still have extended credit to them since they often belonged to the same corporate group. In this context, BI regulations on the maximum exposure to a single borrower and/or affiliated borrowers were often violated. Under the regulation the maximum credit to affiliated companies was placed at 20% of the bank capital. In practice however, private banks affiliated to a conglomerate group channelled sometimes up to 90% of their capital to the same group. In addition, as noted earlier, much of the lending was on the basis of inflated asset values instead of risk assessment.

Another key issue that made fair credit assessment difficult was “political influence.” Loan decisions to well-connected borrowers were often made based on political recommendations or pressure/influence. Furthermore, state banks were often used to channel credit into special projects in which there was political interest, without sufficient assessment of creditworthiness. There was often a blurring between formal financial assessment and political influence/pressure.

6. Weak Corporate Governance of Banks

In general, there was little incentive for banks to be cautious in corporate lending in part because of concentration of ownership. That is, despite the rise in the number of banks and increase in issuance of bank shares in the capital market, the banking sector and ownership of banks remained highly concentrated. For example, in 1996 out of 164 private banks, just 10 banks owned 68% of total bank assets (Pangestu and Habir 2002), and if six state banks are added to these 10, together they account for 75% of total bank assets. And as noted earlier, despite legal limits on lending

¹⁹ On IBRA, see for example Purnomo (2002).

to affiliated firms or to just one group, there was gross violation of these limits. However, as also noted, lack of transparency and suspect accuracy in financial reporting hid this along with other problems until the crisis broke.

Furthermore, as noted, state-owned banks and some private banks were often under political pressure to direct lending to particular sectors or groups without proper evaluation of loans. This amounted to implicit "government guarantees" given to selected groups and state-related banks or corporations. This, in turn, led to a belief that "banks were too big to fail" or more to the point, "too important to fail"; that banks connected to powerful groups would be bailed out by the government under any circumstance. In fact historically, well-connected banks were allowed to stay open, with troubled banks bailed out directly by the government or by corporations at the request of the government, as in the case of Bank Bappindo and Bank Duta.²⁰ In general, there was no effective exit mechanism for failed banks; between 1988 and 1997 only one bank was closed.

7. Inadequate Monitoring

Many of the key problems of inadequate monitoring of the banking sector (by BI) have been touched on earlier. As noted, despite improvements in the regulations on prudential supervision (e.g., in 1991 and 1992), the overall legal and regulatory framework remained weak, especially with respect to loan classification and loan provisions. In addition, the rapidly expanding number of banks following liberalization outstripped the abilities of BI to supervise an increasingly large and complex banking sector. This was further complicated by widespread corruption, and political interference from well-connected bank owners.

The failure to punish banks that violated prudential regulations, did not submit accurate financial reports, or failed to publish key financial information, underlined the weakness of the supervisory and regulatory system; and gave little incentive for banks to adhere more strictly to such regulations. The full implications of the weaknesses of the supervisory and regulatory system were clearly illustrated at the onset of the crisis by the inadequacy of the June 1997 BI data to provide an accurate picture of the status of the banks when reviewed as the basis for the November 1997 closure of the 16 banks, contributing to the failure of that measure. Similarly, the shortcomings of BI's supervisory role was illustrated in gross misuse of the bulk of the liquidity support provided by BI to banks under the pressure of the crisis that did not come to light for several months through audits by international accounting firms under the IMF-led IFI package.

8. Overheating: Expansion of Domestic Credit and Financial Integration

Economic boom and increased international financial integration in the 1980s amplified the structural vulnerability of Indonesia's financial system, in particular the banking sector. Domestically, the government financed itself partly through credit creation by BI. This was used to maintain a high level of employment and to make up for the shortfall between planned

²⁰ See for example O'Rourke (2002) and Schwarz (1999).

government expenditure and tax revenue. With this increased liquidity, domestic banks rapidly expanded credit, especially to risky sectors such as property, and to consumers for stocks. This led to speculation-driven rise in price of these assets. For example, property lending increased from 6% of GDP in 1993 to 16% of GDP in 1996 (Pangestu and Habir 2002).

An overheating domestic economy in the early 1990s led to attempts by the government to tighten monetary policy, driving up high interest rates. However, high domestic interest rates attracted deposits from nonresidents. Furthermore, given Indonesia's open capital account, high domestic interest rates led to an expansion of off-shore borrowing by both banks and corporates at low rates. Although new regulations curbed such borrowings, corporations continued to use short-term foreign currency debt to fund longer-term investments. When the value of the rupiah fell, these banks and corporations were caught by the currency movements as well as falling revenues, and were unable to repay the short-term foreign debt. Through it all, despite increase in risk profile, banks continued to have inadequate provision for bad debts.

C. Summing Up

The rapidity and severity of the onset of the crisis caught the Government of Indonesia and the IFIs generally unprepared.²¹ Although there were clear indications of underlying problems in the financial sector (see for example Cole and Slade 1996, World Bank 1997, Kenward 2002a), the initial strategy under the IMF-led package in effect saw the crisis as a moderate case of contagion. It reflected the assumption that relatively small, marginal interventions in the banking sector such as the closing of the 16 banks in November 1997 were likely to be sufficient to calm investors and restore the stability of the banks and of the economy. A closer look at the failure of these initial measures to restore confidence in the banking sector and stem the tide of the rapidly expanding crisis is instructive in setting the stage for a discussion of the design and implementation of the Program, in the context of the broader reform strategy.

1. Scale and Scope

The closure of 16 small, insolvent private banks involved around 2.5% of the total assets of the banking system in the face of what was becoming a problem of systemic distress. In this context, deposit guarantees covered only a small portion of the value of bank deposits, in an atmosphere of increasing loss of confidence. This initial response therefore reflected limited appreciation of the scale of the problems in both the banking sector and the corporate sector, and the fundamental relationship between the two, within the context of an unexpectedly rapid and severe crisis.²²

²¹ This is not to say that there were no warning signs prior to the crisis. See Kenward (2002).

²² *Scale and Scope*: Although the decision was to close only 16 banks, in fact the prior IFI and BI review found that 26 private banks and eight public banks (two state and six regional banks) were insolvent. But of these, 10 private banks entered into legally binding "nursing agreements" with BI, and therefore could not be closed immediately,

2. Public Awareness and Support

There was limited effort and/or success in promoting public awareness of the issues, and in building public support (stakeholder coalitions) for policy responses. In particular, the criteria for the bank closures were not clearly understood by the public, e.g., what was meant by “insolvency.” This was in the context of general concerns and suspicions that problems ran far deeper than the 16 banks, raising issues in the minds of the public of either inequity of policy, or lack of appreciation of the scale of the problem by the government and IFIs. Therefore public support for policy responses to the crisis (and subsequent policy reforms) was uncertain.

3. Institutional Constraints

The June 1997 banking that was the basis for the November closures did not reflect the actual status of the banks in October 1997. This was in part because of flawed supervisory information from BI (Pangestu and Habir 2002). More fundamentally, this issue reflected a deeper and more pervasive problem: the effectiveness of the institutional framework for overseeing for the financial/banking sector turned out to be far more uncertain and problematic than initially realized.

leaving the 16 private banks for closure. These findings were based on an assessment of the banking sector undertaken by IFIs with BI in October 1997 using June 1997 BI data. In this process the World Bank examined all seven state banks (accounting for 40% of total banking sector assets); ADB examined 13 of the 27 regional development banks (accounting for 2% of total banking sector assets); and the IMF examined 72 of the 160 private banks (43% of total banking assets and 87% of total private banking sector assets). In total, the IFIs examined 92 out of 238 banks or 85% of total banking sector assets. However, this review did not reveal the full extent of the problems in the banking sector, leading to what proved to be insufficient scale and focus of response. The June 1997 BI data did not reflect the actual status of the banks in October 1997, on one hand given the exchange rate depreciation and rising interest rates and their impact on bank (and corporate debtors) balance sheets; and on the other because of flawed supervisory information from BI. As a consequence, the IFIs and the government missed the full scale of the problems in the banking sector and the closely related problems in the corporate sector.

Safeguards: A critical decision taken by the government, supported by the IFIs, was not to provide a blanket guarantee to the depositors of the 16 banks. The government was concerned about the fiscal costs of such an action, while the IFIs' concern focused on the associated moral hazard. A partial guarantee was provided up to Rp 20 million (around \$6,000), in effect providing guarantees for small but not large depositors. This covered 93% of the total number of accounts, but only 20% of the total value of the deposits. It is now widely believed that the decision not to provide a blanket guarantee in November 1997 was a—if not “the”—critical mistake in the bank closure decision, in an atmosphere of fragile public expectations when bank closures can produce adverse results. The implication is that it is not sufficient to compensate only small depositors as banking institutions are closed, since it is the large depositors who are the ones most likely to start a systemwide run on banks and will need some comfort. However, this continues to be a controversial and debated issue both in terms of moral hazard and fiscal cost. For example, providing blanket guarantees later as part of a comprehensive strategy raised significantly the fiscal cost of bank sector restructuring, now estimated at over 50% of GDP.

4. Political Commitment

The political credibility of the bank closure policy was undermined from the outset. In effect, the closures exposed the politicized nature of banking and banking supervision in Indonesia and raised fundamental questions about the political commitment to really address the problems of the banking sector, or more generally, governance problems in the financial sector. In particular, President Soeharto's family challenged the bank closures from the beginning.²³ Therefore it was not clear from the outset to what extent there was ownership of the crisis management and reform program at the highest political levels, and of the role of key stakeholders, including powerful vested interests. This was coupled with a lack of history of successful bank closures in Indonesia that perhaps could have given some credibility to such actions.²⁴

Against this backdrop, by late 1997 and early 1998 the realization set in that the crisis was far more serious than anticipated, and that it threatened a deep, longer-term contraction of the economy. As the situation quickly deteriorated, there was both a significant loss of money ("financing gap") and a fundamental loss of confidence in Indonesia by the international financial community ("credibility gap"), including in the capacity of the government for economic management. This provided the immediate context for the preparation of the Program.

III. EXPLAINING THE ODDS: POLICY REFORM PROCESS AND THE INDONESIA FINANCIAL SECTOR GOVERNANCE REFORM PROGRAM LOAN

A. Introduction

As noted, the Program was part of an IMF-led IFI response to the crisis in Indonesia. Although this case is not intended to be a detailed and comprehensive discussion of either the crisis or the overall response to it by the IMF-led IFI adjustment and reform package, the focus of the case is on the interplay between the Program and the surrounding environment, with particular emphasis on the policy reform process and its political economy dimension. In this context, how the Program evolved and was shaped through key stages of the policy reform process can best be understood only within the broader context of the wider IFI approach, framework, and strategy, and the interplay between the IMF-led strategy and related reactions and developments in Indonesia.

²³ *Political commitment*: President Soeharto's family challenged the closures from the outset. His son, Bambang Trihatmodho, one of the owners, was able to effectively circumvent the closure of his bank by buying a license of another bank. His "new" bank then took over the assets of his "old" bank, and the premises reopened under the new name. BI said that it had no legal grounds for stopping the acquisition. The President's half-brother, Probosutedjo, took sustained legal action against the closure of his bank, Bank Jakarta. According to discussions with a former senior BI official, the Governor of BI had cleared the list of the 16 banks with the President, who had the list in hand for several days and told the Governor that ownership of the banks was "irrelevant." However, it is not clear whether the President understood that his second son was an owner of one of the banks, Bank Andromeda.

²⁴ See for example Kenward (2000) on the difficulties in cleaning up problems in the state banks.

B. Initiating Policy Reform: Getting on the Policy Agenda

1. Crisis as a “Window of Opportunity” for Reform²⁵

The problems and therefore the rationale for reform in the financial/banking sector seem clear from the preceding section. However, as discussed elsewhere (Abonyi 2002), just because problems exist or even are known to exist does not necessarily lead to policy responses. Reforms generally require deliberate actions on the part of political decision makers to initiate change: to place problems and associated reforms on the policy agenda—the critical initial step in the policy reform process. Given the uncertainties and risks associated with policy reforms as “systemic change”, and therefore a not unusual reluctance to undertake such change, crises are often seen as providing “windows of opportunity” for launching such reforms.

Policy reform in the financial sector, initiated in the midst of the crisis in Indonesia, followed this pattern. In particular, reforms aimed at *governance* issues in the financial sector through the Program were a direct consequence of the crisis—with the term “governance” introduced into the focus of financial sector reforms for the first time by the Program. An important issue that must then be considered with all crisis-induced change is how likely is it that reforms launched under such exceptional conditions will indeed be implemented and sustained beyond the immediacy and urgency of a crisis—an issue that will be considered later in the paper.

2. Crisis, Financial Sector Reforms, and the Policy Agenda

(i) Congruence with the Policy Agenda

As the Program was part of an IMF-led IFI response to the crisis, the relationship between its scope and focus, and the government’s policy agenda has to be considered within the broader context of the congruence between the IMF-led reform package and the policy agenda. Furthermore, since the Program was designed during November–December 1997, with some refinements in early 1998, it is especially important to understand the evolution of the IMF-led adjustment and reform program during this period.

The extensive shorting of the rupiah by foreign exchange traders in early August 1997 triggered the onset of the crisis in Indonesia, which then swept over the financial/banking sector leading to a dual gap: financial gap and (policy) credibility gap. As a consequence and shaped by ongoing crisis-related dialogue with the IMF, financial/banking sector problems were high on the government’s policy agenda.

This is reflected in the first LOI signed between the Government of Indonesia and the IMF on 31 October 1997. In general, the IMF LOIs, in providing the umbrella framework for the participation of IFIs in supporting the Government of Indonesia, should have been consistent with the policy agenda of the government. More specifically, the first LOI included measures aimed

²⁵ For further discussion of “crisis as a window of opportunity” see Abonyi (2002) and Abonyi (2005).

at financial sector restructuring (i.e., November closing of the 16 banks); a macroeconomic program including macro targets, fiscal measures, and monetary and exchange rate policy measures; and additional structural reforms relating to the “real sector” (e.g., phasing out selected monopolies).²⁶

Efforts to control the crisis through the measures in the first LOI were unsuccessful.²⁷ Throughout November and December 1997 the crisis deepened and widened. The IMF review mission (25 November–11 December 1997) lay much of the blame for the rapidly worsening situation on the *lack of commitment* by the Government of Indonesia to implement the adjustment measures and policy reforms in the LOI.

A lack of commitment by the government would indicate that there was insufficient congruence between the adjustment and reform measures in the first LOI, and the Government of Indonesia’s policy agenda. Indeed on closer inspection, this seems to be the case. For example, there are indications that members of the government negotiating team were not convinced of the necessity or advisability of real sector structural reforms included in the first LOI, subsequently greatly expanded in the second LOI.²⁸ More fundamentally, although there was the highest level technocratic participation in negotiating the first LOI,²⁹ there are strong indications that key areas of focus in the LOI were essentially not on the government’s policy agenda in terms of having—or being able to generate—the political support necessary (from President Soeharto) for ensuring that these reforms were, and would remain, policy priorities.

The primary motivation of the government in negotiating the LOI in the midst of a rapidly worsening crisis seems to have been based less on a domestic policy agenda focused on reform, and more on securing critical IMF-led IFI support to address the financial and credibility gaps in the crucial initial stages of the crisis. From this perspective, potential longer-term benefits of specific measures were seen as less important than their immediate financing and confidence building role in stabilizing a collapsing economy.³⁰ Furthermore and more fundamentally, it is not clear to what extent President Soeharto saw as essential the role of the IMF and the IFIs from the outset. The decision to call in the IMF originated with senior technocrats and the Minister of Finance. There seem to have been some difficulties in convincing President Soeharto of the need for the IMF.³¹ Therefore it was not at all clear what specific issues and reforms in the first LOI were on the government’s policy agenda as genuine domestic priorities, reflecting the necessary high-level political support.

²⁶ For details see Indonesia Letter of Intent, 31 October 1997 (IMF 1997).

²⁷ There is strong criticism that the IMF program, as reflected in the first LOI rather than part of the solution, was part of the problem; that the IMF by insisting on fiscal tightening and cutting government spending when the Government of Indonesia had not been running a budget deficit contributed to and accelerated the downward spiral of the economy. See for example Radelet and Sachs (1998).

²⁸ Based on interviews with key participants in the process. See also Boediono (2002).

²⁹ The first LOI (October 1997) was negotiated by prominent Indonesian technocrats including BI Governor Soedrajat, Ministers Mar’ie Muhammad, Moerdiono, and Tunky Ariwibowo, with input from Professors Widjojo Nitiastro and Ali Wardhana; details of the program were negotiated by Boediono, Bambang Subianto, and Djunaedi Hadisumarto. See for example Kenward (2002).

³⁰ Based on interviews with key participants.

³¹ See for example Kenward (2002).

In the face of the failure of the November 1997 bank closures and a rapidly worsening crisis, a more comprehensive strategy was agreed on between the government and the IMF on 15 January 1998 in a Memorandum of Economic and Financial Policies (second LOI), and followed by the announcement of additional measures by the government. This was against a backdrop of a plummeting rupiah, which fell to Rp 11,000 to the dollar in reaction to the government's 6 January budget that was seen by critics as unrealistic and inconsistent with the IMF program,³² coupled with growing social unrest reflected in panic food buying. The new strategy included the following key components with respect to the financial sector: (i) comprehensive bank restructuring plan; (ii) general ("blanket") guarantee scheme; and (iii) creation of the IBRA as a combined bank restructuring and centralized public asset management agency. At the same time, with the intent of restoring confidence, the revised second LOI placed greater emphasis on structural reforms, expanding their scope, and including cutting subsidies, ending market-distorting cartels and monopolies, and privatizing state-owned enterprises (SOEs).

Furthermore, unlike the first LOI, negotiated and signed by senior technocrats representing the government, President Soeharto seemed to put his personal political power behind the second LOI. He took two extraordinary steps to seemingly ensure that the reforms under the IMF-led package were visibly on the government's policy agenda. First, President Soeharto was personally involved in the final stages of negotiations with the IMF on the second LOI, co-signing with the Managing Director of the IMF. Second, in a highly unusual step, he held a 1-hour televised briefing to the nation on the economic reforms from his personal residence (Kenward 2002).

Yet, the shift in focus of the IFI reform package raises even more sharply the question: To what extent were issues addressed in the second LOI on the government's policy agenda—in terms of having the necessary political support? Focusing on structural reforms increased the political content of the reform program. That is, such reforms were likely to have direct and immediate impact on particular—and particularly powerful—vested interests, including President Soeharto's family and friends. Therefore for such measures to be credible, they required clear, visible, and sustained political commitment at the highest levels all the way to the president. This seemed at first to be the case with the president's direct involvement in the second LOI. However, essential political commitment had not been demonstrated up to that point in the context of the crisis,³³ and as lagging implementation of the second LOI quickly made clear, real presidential commitment to reform continued to be missing. This was reflected in the currency board debate where President Soeharto directly challenged the basic approach to exchange rate management under the IMF-led program; and in the lack of implementation of key structural reforms, such as dismantling the plywood cartel and removing monopolies in the trading of key commodities.³⁴ As the crisis worsened, President Soeharto increasingly lost confidence in both the IFIs' and the government technocrats' ability to manage events and therefore to shape the policy agenda.³⁵

³² For a more sympathetic and detailed discussion of the January 1998 budget see Kenward (2002).

³³ For example, as discussed earlier, the failure of the closure of the 16 banks in November 1997 was related to insufficient political support for the measure. Similarly, on 1 November President Soeharto approved 15 large investment projects—postponed from September in the name of fiscal restraint—that involved his family and close associates (Kenward 2002).

³⁴ See for example Kenward (2002), Schwarz (1999), and O'Rourke (2002).

³⁵ Based on interviews with key participants; see also Boediono (2002).

In sum, the crisis pushed financial/banking sector-related problems to the top of the government's policy agenda. However, there were fundamental differences between measures in the IMF-led reform package that went well beyond addressing issues related to the financial/banking sector, and a politically viable domestic policy agenda—apparent involvement of the president notwithstanding. Therefore as the case reflects, the question with respect to the placement of reforms on the policy agenda is not only whether such measures were *relevant*, that is, reflected problems that needed to be addressed by the Government of Indonesia. A key question is also whether such reforms were *feasible* in terms of being able to generate sufficient political support for real endorsement (binding commitment), and sustained implementation. The implication of the analysis in the case is that even if reforms are relevant, if they are not feasible in that they do not have the necessary political support (or as will be discussed, the required institutional capacity), they are unlikely to be implemented and/or sustained.

(ii) Congruence among the Policy Agenda, the Program, and the Policy Challenges

In the context of the ADB Program, it is important to look at not only what was included on the policy agenda, but also what was excluded. The financial sector, more specifically the banks, was assumed by both the government and the IFIs to be the epicenter of the early stages of the crisis. However, although there were indications of the problems in the corporate sector prior to the crisis (see for example Halim 2000, Kenward 2002, Pangestu 2003), neither the IFIs nor the government recognized the full extent of the corporate debt problem, discussed earlier, and its implications for the financial/banking sector in the context of the crisis. In effect, Indonesia was not facing a financial/banking crisis, but systemic distress: a twin crisis of the banking and corporate sectors that were closely intertwined and required simultaneous attention.³⁶ Therefore corporate debt/corporate restructuring was a critical area whose relevance and importance was not sufficiently reflected either in the IFI adjustment and reform package, or on the Government of Indonesia's policy agenda.³⁷ This is not to say that the issue remained completely off the policy agenda: there was increasing awareness of this issue, and some limited measures introduced to address it. However, there was insufficient recognition of the critical importance of corporate-based problems to the financial sector, and therefore limited measures introduced to address it (see Appendix 2).

The risks to the banking sector of the expansion of corporate debt and the related failure of credit assessment were touched on earlier, but the importance of this issue requires further comment (see Appendix 2 for more detailed discussion). The problems that surfaced in the financial/banking sector could be seen as originating even deeper than the nature of bank lending to corporates. The books of the corporates were fundamentally distorted: they did not reflect accurately the real value of their assets (overstating them for borrowing purposes), nor did they reflect the true risks in their liabilities (understating their exposure). Lack of transparency and accuracy in corporate financial reporting hid the real status of corporate balance sheets. This distorted both corporate investment decisions, and lending decisions of banks toward corporates. As noted earlier,

³⁶ See for example Haggard (2000) and Kenward (2002).

³⁷ Based on interviews with key participants. This was not unique to Indonesia in the context of the Asian crisis. For the Thai case see Abonyi (1999).

banks contributed to and compounded distortions in the economy by failing to perform the basic function of screening in corporate lending, leading to distortions in the balance sheets of the banks as well. This was a function in part of corporate financial disclosure issues, as well as other factors noted earlier, in particular, “directed lending” (both politically inspired, and to related companies within the same group).

To state the issue differently, lack of “good governance” in the corporate sector became a source of fundamental distortions in the financial sector—compounded by lack of “good governance” of banks. The implication is that banking sector and corporate sector restructuring were in, effect, two sides of the same coin; both needed to be addressed *simultaneously*. Financial/bank sector restructuring is necessary, but unless parallel restructuring takes place in the corporate sector, it is not sufficient to create a viable financial sector.³⁸ However, since the issue was not a priority on the policy agenda, it was not adequately addressed.³⁹

3. Role of the ADB in Setting the Policy Agenda

Since the focus of this case is on the ADB Program, it is useful to put into context ADB’s role in the early stages of the crisis. ADB was not involved in discussions in the early stages of the crisis that shaped the policy agenda and the context of the Program, joining the IMF-led effort later in the process.⁴⁰ For example, key early decisions taken within the IMF-led LOI framework without substantial ADB involvement included the initial closing of the 16 banks, and the introduction of a deposit guarantee scheme.

More generally, ADB’s role as part of the IMF-led IFI effort through the LOI process had a dual effect. On the one hand, it increased ADB’s influence with respect to the policy agenda and helped shape the design of the Program.⁴¹ At the same time, the linkage between ADB’s role and

³⁸ In this context, a very different perspective on the crisis is to see it as a loss of confidence not primarily in the banks as was the conventional wisdom, but in the corporates. That is, the financial markets realized in 1997 the accumulation of problems originating in the corporate sector, and the drastic plunge in the rupiah reflected an assessment and reaction by the markets to these deeper concerns. That is, there was a realization that the liability side of the corporate balance sheet was vulnerable (dollar-denominated debt rises in rupiah); while the asset side was overstated. This, in turn, had critical implications for the state of the banks—undermining confidence in both the “real” and financial sectors—a situation not fully understood at the time by the government or the IFIs. (Based on extensive discussions with key players in both the Government of Indonesia and the IFIs.)

³⁹ That is not to say that it was completely ignored. In particular, the Program included measures related to corporate financial disclosure/corporate governance (e.g., condition 19.1, see Appendix 1). However, as will be touched on later, these were not seen at the time as “core” issues of needed reforms to address the crisis or to restoring the health of the Indonesian economy.

⁴⁰ ADB was invited to join the IMF mission in August–September, 1997, by which time the IMF–Government dialogue was already well under way.

⁴¹ Therefore at the time of the crisis, ADB’s increased profile and role as part of the IMF-led effort increased its potential policy influence. In effect, this was the result of a “double need.” The government needed money: as much as possible, as quickly as possible, both for financing and as an expression of confidence by the international community. The IMF to some extent needed the multilateral development banks’ support to extend its role in a range of nontraditional areas, leveraging its considerable pressure even further and wider. As a consequence, ADB was able to have policy influence beyond what it could have had on its own, going beyond the details of the policy matrix. For example, ADB became involved in the audit of state-owned enterprises, considered an important breakthrough.

the IMF through the LOI process also reduced ADB's potential flexibility in accommodating any deviations between the government's policy agenda and the wider IMF-led adjustment and reform program. That is, because of cross-conditionality, ADB funds could not be disbursed independently unless the IMF was satisfied with overall progress under the terms of the LOIs.⁴² This made ADB to some extent part of the IMF-government dynamic, including any accompanying stresses and strains between the two with respect to what should be included on the policy agenda.

Operationally, this linkage was less of a factor with respect to the actual design and implementation of the Program. Once ADB's general "scope of work" was agreed on within the IMF-led IFI framework, program implementation remained relatively separate and independent from the core of the IMF-driven strategy.

C. Managing Complexity: Design of the Program

1. Complexity of Policy Issues and Program Design⁴³

Policy issues are complex in part because of the political nature of policy issues and because of the diversity of institutions that play a role in the policy reform process. A different dimension of complexity relates to the very structure of policy issues. Such issues generally involve many elements and interconnections ("feedback") among these elements through which change or reforms may be transmitted or cancelled out. For example, assessment of risks associated with a loan to an enterprise is a function of the credit assessment process used by the lending bank, as well as the quality of financial information available from the borrowing enterprise. There are typically various leverage points where reform initiatives may focus in order to help bring about desired outcomes in strengthening the bank's loan portfolio. For example, financial sector reforms may focus on the procedures and governance issues of the banks exemplified by improvements in the credit assessment process and related incentives of banks; or on the financial reporting process and governance issues of corporates, such as improvements in the accuracy and quality of corporate financial reporting.

As reflected in this example, generally there are interconnections among different dimensions of a policy issue and/or between what may be framed as different policy issues, such as "financial sector governance" and "corporate governance." This makes it difficult and somewhat arbitrary to define boundaries for what should be part of a particular reform program, and what may be excluded. In the above example, should "corporate governance" issues be included as part of a focus on financial sector governance reforms? Should it be treated as a separate but related priority policy issue? Or can it be treated as a separate issue of lesser priority and importance?

How a policy issue is posed or structured therefore plays a significant role in shaping policy reforms that are intended to address it. The design of a reform program is the process through which the complexity of policy issues is addressed—where boundaries are drawn, and where decisions

⁴² For example, on 6 March 1998 the IMF suspended disbursement of the \$3 billion second tranche, and on 10 March, ADB and the World Bank followed.

⁴³ For further discussion of complexity of policy issues see Abonyi (2002) and Abonyi (2005).

are made about the focus of measures intended to bring about improvements. In practice, political decision makers at the outset of the reform process often are unable to articulate a clear sense of the policy problem and required solutions (i.e., scope, focus, and structure of the reform program). Therefore “design teams” are often given considerable latitude early in the policy reform process to define the scope, focus, and structure of the reform program; the associated gains and losses from reform initiatives and therefore “reform winners” and “reform losers”; as well as the institutional requirements of implementing reforms. Program design decisions then shape the subsequent policy reform debate and the implementation process.

2. Design of the Program

(i) IFI Coordination: Setting Program Boundaries and Scope

The scope, boundaries, and focus of the Program was defined within the framework of the IFI support package to the Government of Indonesia. The IMF took the lead in the design of the overall IFI strategy, formulating the first LOI as a traditional IMF program. With the shift in emphasis in the revised (second) LOI focusing more on a structural reform agenda, the role of the multilateral banks expanded, particularly that of the World Bank. To put ADB's general role in Indonesia in context, prior to the crisis, ADB was a well-appreciated source of financing to Indonesia, but historically played a lesser policy advisory role in that country—earlier program loans related to the financial sector in Indonesia notwithstanding⁴⁴—than the IMF, a generically “policy institution”, or the World Bank with its long history of policy-related involvement.

In this context, ADB's scope for supporting policy reform in the financial sector reflected prior decisions by the IMF (and to a lesser extent by the WB) as to who will address what issues within the IFI framework. In general, the IMF was to play the lead role, focusing on monetary sector and the BI; the WB was to focus on state banks and core private banks; and ADB took responsibility for some private banks and regional banks, and selected nonbank financial sector issues. Operationally, this arrangement meant that implementation of the ADB Program was to a large extent insulated from the increasing complexities and at times significant strains of the IMF–government relationship.

The coordination between the IMF and ADB was problematic at the crucial Program design phase in late 1997 and early 1998, affecting the design and approval process. This was the result of both a lack of an effective IFI coordinating mechanism in the early stages of the crisis, as well as policy-related differences between the two institutions. For example, the ADB had a dissenting view on the introduction of the blanket deposit guarantee in January 1998, advising the IMF of its concern about the “moral hazard” of such a scheme. Furthermore, ADB had reservations about the January 1998 decision to establish the IBRA to serve as the special purpose institution both

⁴⁴ There were two such loans prior to the Program, in 1988 and 1992.

for restructuring the banks and as an asset management company to handle NPLs.⁴⁵ This critical decision was taken without ADB's participation in key discussions, yet it related to a core focus of the ADB Program being prepared at the time.

It is not clear if ADB's early involvement with the IBRA-related discussions would have changed the actual Program design or the contents of the policy matrix. However, differences over IBRA delayed the *timing* of Program approval. The original Program document was circulated to the ADB Board in January 1998 in an attempt to get the needed funds as quickly as possible to the government. However, because of the differences over the IBRA issue, ADB's Program approval was delayed until late June 1998, as stated in the IMF's external evaluation.⁴⁶

It is important to stress that coordination problems between the IMF and ADB were present only at the early stages of the process—which coincided with the Program design phase. By the first quarter of 1998 an effective partnership had evolved between IMF and ADB (and more generally among the IFIs), with generally good communication, informal coordination, and joint participation in key meetings and policy dialogue.⁴⁷ For example, ADB was involved in subsequent IMF–government LOI discussions, and was able to review drafts and provide inputs. Therefore the relationship between ADB and the other IFIs increased ADB's participation and influence in the reform process. At the same time, operationally, given the agreement among the IFIs on relative roles, ADB carried on relatively independently the detailed design and implementation of the Program.

(ii) Design and Approval Process

Following ADB's first participation in a crisis-related IMF-led policy dialogue mission with the Government of Indonesia in September 1997, the \$1.4 billion Program was put together in about seven weeks during November–December 1997, in the midst of a rapidly deteriorating situation. This was an extraordinary response time for a Program of this size, under prevailing conditions. The original Program went to the ADB Board in January 1998, was withdrawn as noted earlier, then approved on 25 June 1998.

The Program was designed and approved in the middle of a rapidly deepening and widening crisis, whose full impact and implications were not understood at the outset either by the government or the IFIs, and which rapidly evolved from a financial, to an economic, to a social, then political crisis. This increasingly turbulent environment conditioned the Program design and approval process. To put this in context, key developments in Indonesia during this period (November 1997–July 1998) are summarized in Box 1.

⁴⁵ The alternative view was to address the problem of nonperforming loans through a market-based approach involving pushing the banks to dispose of bad assets through the private sector, rather than establishing a monolithic government agency to run the process.

⁴⁶ The IMF's independent evaluation summarizes the issue thus: "Citing confidentiality... the IMF staff did not keep the ADB team fully informed of the issues being discussed with the Indonesian authorities. The relationship was cool at best, and continued to deteriorate until the end of January 1998, when the ADB temporarily pulled out of the collaborative relationship with the IMF over disagreement on the creation of IBRA. The first ADB program loan for US\$1.4 billion was not approved until June 1998" (IMF 2003, 82).

⁴⁷ Based on discussions with key participants from all the IFIs.

Box 1
CONTEXT OF PROGRAM DESIGN AND APPROVAL (NOVEMBER 1997–JUNE 1998)

- 5 November 1997:* PT Bank Andromeda, one of the 16 banks closed and partly owned by President Soeharto's son, files lawsuit against Minister of Finance and BI Governor, challenging bank closure
- 11 November 1998:* President Soeharto's son buys a small bank and starts business on the old premises of Bank Andromeda, in effect challenging the bank closures
- 12 December 1997:* President Soeharto begins unprecedented 10-day home rest—creating uncertainty about his health
- 30 December 1997:* Jakarta court decides to delay liquidation of PT Bank Jakarta (one of the 16 banks closed), owned by President Soeharto's half-brother
- 6 January 1998:* President Soeharto presents a budget, including a 32% increase in government spending, which critics call unrealistic and say does not conform with the IMF's reform program
- 8 January 1998:* Rupiah falls to 11,000
- Early January 1998:* Rising prices, fears of shortages lead to panic buying of food
- 13 January 1998:* Students in Jakarta protest IMF-imposed policies
- 15 January 1998:* President Soeharto signs Memorandum of Economic and Financial Policies (second LOI) with the IMF, focusing on structural reforms; rupiah continues to fall
- 21 January 1998:* President Soeharto announces Minister Habibie as Vice President candidate; rupiah falls to 16,000
- 27 January 1998:* Government announces key measures to address financial sector problems, including full guarantee of commercial bank deposits and credits and establishment of IBRA
- February 1998:* Domestic economic debate focuses on proposal to establish a currency board for exchange rate management—resulting in strong, critical reaction from IFIs and the international community
- 2 March 1998:* President Soeharto states that implementation of the structural reforms under the IMF program is incompatible with Indonesia's constitution
- 3 March 1998:* Senior US officials say the US will not support the IMF's next loan to Indonesia disbursement without "adequate" progress on reforms
- 7 March 1998:* IMF announces delay of \$3 billion disbursement, suggesting President Soeharto's unwillingness to implement the reform program
- 10 March 1998:* People's Consultative Assembly (MPR) selects President Soeharto for a seventh 5-year term, and B. J. Habibie as Vice President
- 14 March 1998:* "Seventh Development Cabinet" is sworn in, including President Soeharto's daughter, "Tutut", as Minister of Social Affairs, and long-time close presidential friend and timber mogul Bob Hasan as Minister of Industry and Trade
- 4 April 1998:* Government announces fuel hikes; riots break out, prices rolled back
- 8 April 1998:* Government and IMF reach agreement on revised (third) LOI
- 22 April 1998:* Government announces reforms, including amended bankruptcy law, identification of SOEs for privatization, and steps on corporate external debt
- 4 May 1998:* Government announces fuel price hikes, riots follow, price hikes rolled back; IMF resumes stalled lending program
- 5 May 1998:* Students hold demonstrations across Indonesia, protesting steep fuel and energy price hikes and demanding extensive political reforms
- 12 May 1998:* Troops fire into a student protest at Trisakti University in Jakarta, killing six
- 13-15 May 1998:* Rioting, arson, and looting spread in Jakarta and other cities, leaving an estimated 1,180 dead

15-17 May 1998: IMF, embassies, foreign companies, World Bank evacuate nonessential staff
18 May 1998: WB postpones two loans (totaling \$1.225 billion) due to go to the Board
19 May 1998: President Soeharto delivers speech pledging to resign and appoint council to draft new election laws; rupiah rebounds from 17,000 to 12,700
19 May 1998: Students take over parliamentary complex for three nights
20 May 1998: 14 ministers from President Soeharto's cabinet resign
20 May 1998: Parliament, students give President Soeharto deadline to resign by 22 May
21 May 1998: President Soeharto resigns after 32 years in power, and is succeeded by Vice President Habibie
22 May 1998: New Cabinet announced, dropping President Soeharto's daughter and Bob Hasan; IMF postpones disbursement of \$1 billion scheduled for 4 June
27 May 1998: President Habibie announces elections will be held in 1999
24 June 1998: Government and IMF reach agreement on revised (4th) LOI
July 1998: Pro-independence demonstrations break out across Irian Jaya
Late 1998: Rioting continues across Indonesia; violence escalates on East Timor, and Aceh businesses owned by the Chinese minority are targets of arson, looting

A basic challenge to designing reforms under crisis conditions is balancing or linking longer-term reforms with the urgency of responding to a deep systemic crisis. In the face of a crisis slipping out of control, the overriding concern of both the government and ADB at the Program design and approval stage was speed—to help the government respond to a rapidly deteriorating situation. There was limited discussion of long-term policy reform and implementation requirements, including issues such as institutional capacity and inter/multi-institutional coordination needed to undertake prescribed actions. Therefore issues involving differences in perspective (including within the ADB team) that under different conditions would perhaps have been more closely scrutinized and debated (for instance the Secondary Mortgage Facility included in the policy matrix), received even more limited attention, in order not to delay Program design and approval. In this context, the addition of a \$50 million technical assistance (TA) to the Program could perhaps be seen as “risk and uncertainty mitigation” to provide resources to address likely implementation problems.⁴⁸

Placing the Program design and approval process within the timeline of the broader IFI relationship and its implications for government financing requirements sheds further light on the sense of urgency that permeated the process. Negotiations between the government and the IMF, already strained by the currency board issue (see Box 1), effectively broke down in mid-1998 as the crisis accelerated, and social and political instability increased. The IMF and the World Bank froze discussions with the government. Faced with a contracting economy and a collapsing rupiah, and given the uncertainty with respect to IFI financial support, the Ministry of Finance (MOF) froze all expenditures and investments.⁴⁹ These developments contributed to a quickening sense of

⁴⁸ Based on discussions with key participants.

⁴⁹ The issue of the fiscal conservatism of the Ministry of Finance vs. public investment to “kick start the economy”, as advocated by some line ministers, was an important issue in later stages of the crisis, i.e., under President Wahid. (Based on discussions with former ministers.)

urgency by the government and ADB with respect to the Program. In this context, it should be noted that issues addressed by the Program were for the most part primarily technical and therefore less controversial than those addressed by the IMF and World Bank, such as dissolving plywood and clove monopolies and cartels (second LOI).

It is important to keep in mind that at the time of the Program design (November–January 1998) there were no signs of the fundamental political changes that were to occur later in the year. There was an implicit assumption by ADB (the IFIs in general), as well as the government in the design of the Program that its implementation will take place within the framework of the existing economic management and political system. Yet by the time the Program was approved in June 1998, the environment was fundamentally changed. President Soeharto was replaced by President Habibie after the May 1998 riots, and there was a feeling of deep political concern and urgency for ADB to support the new government and a transition to democracy. However, even in June it was not yet fully understood how fundamentally the Indonesian political context had changed: events were moving too fast. The political system had indeed changed irrevocably. The centralized and personalized presidential system in place under President Soeharto was changing into a pluralistic system, with multiple and competing political players emerging in a parliament that was taking on an increasingly stronger and independent role. The implications of these unfolding changes were not reflected in the Program design approved in June 1998, and were to play a role in the implementation process.

In this environment the ownership of the Program (and more broadly, the IMF LOIs), was limited within the government bureaucracy. Furthermore, by mid-1998 the role of bureaucrats was constrained in a policy process increasingly dominated by higher-level politics. At the political level—characterized by changes and basic concern with retaining power (President Soeharto to President Habibie then to President Wahid)—the focus of the government was more on the political and social impacts of the crisis and the need to bring it under visible control, rather than on issues of longer-term policy reform. The implication is that the actual ownership or “buy in” by the government to the Program—and more generally to the IFI adjustment and reform package—at both the political level and within the bureaucracy was limited, particularly under the pressures of a deep crisis.

In this context, the design process reflected that in general, the IFIs were very ambitious at the onset of the crisis. They saw it as an opportunity for significant changes and reforms, as embodied in the earlier LOIs. For example, the Program’s first policy matrix was very broad, with over 100 conditions. In general, as it turned out, the government was being asked to implement far more than it could—either politically or in terms of institutional capacity—in the context of an increasingly turbulent environment. This general approach, combined with a focus on speed of response given the urgency of the crisis, meant that there was limited focus on implementation requirements, including institutional capacity constraints, rigidities, and bottlenecks; political uncertainty and transition and their implications; and the exceptionally deep nature of the crisis and its political and social implications on implanting reforms.

The limited attention to implementation was also a function of the participants in the Program design process. The core design team included ADB staff, working primarily with a small group of senior officials in the MOF led by the Director General, Financial Institutions. Although Program implementation was to involve a number of agencies at various levels, including coordination requirements among them, there was limited participation in the Program design by these

implementing agencies. A “managerial perspective” on the design of the Program focusing on the operational requirements of the reform measures in the policy matrix was generally absent.⁵⁰

Furthermore, given the broader IFI context, the Program was also subject to “external interests” (not solely arising from ADB-government policy dialogue). In particular, the requirement for legislation to prevent money laundering did not arise solely from policy dialogue and joint concerns of the ADB and government, but was inserted into the Program late in the process.⁵¹ At the time of its inclusion in the Program design this measure was not seen as central to the management of the crisis or a core issue in long-term reform of the financial sector. Therefore there was limited background or preparation in including this measure as Program design was being completed. Perhaps partly as a consequence, this measure turned out to be a key source of considerable delay in Program implementation (release of the third tranche).⁵²

In general, the Program design process involved “rolling in” a wide range of issues related to the banking sector, capital markets, and financial sector governance—all deemed to be relevant to both crisis-related issues and longer-term reform of the financial sector. The Program therefore had very wide scope, and the policy matrix went through many iterations. Since the crisis involved a basic discontinuity from ADB’s earlier operations in Indonesia, the Program was improvised, driven by the urgency of events, to provide critical financing to the government. In this, the Program also to the extent possible built on projects and programs that were at various stages of preparation prior to the crisis as part of ADB’s Indonesia country program and associated policy dialogue, such as work related to regional development banks, capital markets, and BPKP (State Audit Board).

(iii) Outcome of Program Design Process

The Program was formulated by ADB as a three-tranche loan of \$1.4 billion, with the first tranche of \$550 million to be released in June 1998, the second of \$500 million to be released in August 1998 (actual release date was in March 1999), and the third and final tranche of \$350 million to be released in February 1999 (actual release date was 5 July 2002). Given the speed of design and the very wide scope of the Program, a \$50 million technical assistance loan was provided to support Program implementation (bank restructuring, institutional strengthening of various government agencies). In addition, an investment loan of \$50 million (\$47 million as loan, and \$3 million as equity investment) was provided for the establishment of a Secondary Mortgage Facility (SMF) (Asian Development Bank 1999). In general, the Program was intended to respond to the immediate needs of the crisis, and at the same time initiate longer-term reform to reduce vulnerability to future crises arising from weaknesses in the financial sector.

The overall objective of the Program was to improve the governance of financial and public sector allocation of resources through: (i) adopting best financial governance practices; (ii) increasing the disclosure and transparency of financial information; and (iii) strengthening the legal and regulatory framework for the financial sector. To achieve these objectives the Program was very comprehensive in scope, including 83 reform measures (many with submeasures), and involving

⁵⁰ From interviews with key participants.

⁵¹ From interviews with key participants.

⁵² This activity/condition was not seen as central to either the crisis or its management, but did take on special importance following 9/11.

a number of implementing agencies.⁵³ The Program timetable required the government to implement this comprehensive and wide-ranging program of policy reforms in the financial sector within a relatively short period of approximately 18 months.

In general, elements of the policy matrix addressed important issues in terms of the longer-term transformation of the Indonesian economy. The core focus of the Program was on financial governance, thought to have been neglected in the earlier rapid liberalization and expansion of Indonesia's financial sector that helped to create conditions for the deep crisis. Other important measures included a focus on anticorruption, corporate governance, audit of SOEs, and transparency in the privatization of SOEs. In general, the issues included in the Program were for the most part ones that the Government of Indonesia was going to have to address at some point, and the crisis was seen by the IFIs and reformers within the government as providing an opportunity to put them on the table.

In this context, the problems of the corporates and their impact on the financial sector, touched on earlier, requires further comment. As noted, this issue, which contributed greatly to the crisis and was (and remains) a fundamental long-term challenge for the Indonesian economy, was not sufficiently appreciated at the outset either as reflected on the government's policy agenda or in the IMF-led IFI reform program. However, this is not to say that it was completely ignored. For example, the design of the Program touched on issues of corporate financial disclosure/corporate governance (e.g., condition 19.1 relating to the filing of audited corporate financial reports). However, the critical importance of this general issue either to the crisis or to the role of the corporates in the recovery of the financial sector, and more fundamentally, in the transition to sustained growth of the Indonesian economy was not fully appreciated at the time of Program design (and implementation).⁵⁴

In sum, the Program design was seen as generally *relevant* to the government's reform agenda. The issue of the *feasibility* of the implementation and sustainability of the measures in the policy matrix that received far less attention in the design process will be touched on again later.⁵⁵

D. Endorsing Reforms: When is Government Commitment "Binding"?

In principle, policy reforms are endorsed through a process of political decision making about proposed policies and changes in policies. In this process, which generally has both formal and informal dimensions, reforms are discussed, debated, approved, modified, or rejected by

⁵³ See the policy matrix in Appendix 1 in Asian Development Bank (1998).

⁵⁴ Condition 19.1 reads (see Appendix 1): "Issue regulations requiring the filing and public accessibility of audited financial reports of corporations with total assets of RP50 billion and above; issue a decree on full disclosure of financial performance of the above corporations." As noted, this condition was not seen at the time as a core condition, and did not receive attention in subsequent government-ADB discussions. Yet as discussed in the case and in Appendix 3, it touches on the core of a fundamental issue that led to the crisis and requirements for reform. Similarly, examples of other conditions that were relevant to this general issue of corporate financial disclosure and governance include 13.5 and 14.3 (related to accounting and auditing standards), and 14.1 (corporate governance). See Appendix 1.

⁵⁵ See Abonyi (2002) on the concepts of "relevance" and "feasibility" in policy reform.

participating political decision makers within the country's existing institutional framework.⁵⁶ The output of the policy decision process is deemed, at some point, to be decisions endorsing (if approved) a program that signals the binding commitment of the government to undertake the approved reform actions. This is expected to lead to instructions to implementing agencies on the priority of the reform measures, and to the allocation of the necessary resources, e.g., through the budgetary process, for implementing such reform initiatives.⁵⁷

In reviewing the endorsement of the Program, it is important again to set it in the larger context of the IMF-led package. Although the Program technically involved a bilateral agreement between the government and ADB, implementation and sustainability of many of the reform measures in the policy matrix were a function of a broader endorsement of the IMF-led package. From this perspective, it seems that in practice, it may be difficult to identify in the policy decision process a "stopping point" that results in a binding or irreversible commitment to reform by political decision makers. For example, uncertainty related to endorsement of reforms was a function of weak or shifting political support (by President Soeharto in the early stages of the crisis); changes in key political decision makers (four presidents during the life of the Program); and changes in the political decision system (shift from a highly centralized political and policy decision system with a powerful president to a more pluralistic system with an increasingly active Parliament). Therefore at various stages the reform package was formally endorsed; endorsed but key measures not implemented; or endorsed but key measures reversed.

For example, signing by the government of each of the IMF LOIs would seem to indicate at each stage an endorsement of and presumably binding commitment to the reform program. However, as the first LOI illustrates, in practice, this is not quite the case. The first LOI was signed by the Minister of Finance, but as noted earlier, given the highly centralized policy decision system under President Soeharto it is not at all clear that the reform strategy had the necessary political endorsement of the president. In fact there are indications that President Soeharto was reluctant to call in the IMF in the first place. Furthermore, as reflected in the difficulties in implementation of the first LOI (with the November closing of the 16 banks) and especially with the second LOI that personally involved the president (lack of implementation of structural reforms), the necessary political commitment to reform under President Soeharto was never fully in place.

Similarly, President Wahid (who succeeded President Habibie) intervened directly in several key financial/corporate restructuring cases. This was seen as undermining the basic role of IBRA and the financial sector restructuring and reform process. This, coupled with inaction on basic reforms of the legal system⁵⁸ seen as essential for financial sector and broader economic reforms, indicated limits on the necessary presidential endorsement of the reform agenda, in practice—one the government formally endorsed in signing the LOIs.⁵⁹

⁵⁶ That is, endorsement is a function of the actual political institutional framework for policy decisions. For example, in Indonesia under President Soeharto this required endorsement by the president. After his fall, endorsement of policies involved a changing political institutional framework, with an increasingly powerful role for a genuine multiparty Parliament in the policy decision process.

⁵⁷ See for example Abonyi (2002), Grindle and Thomas (1991), and Grindle (2001).

⁵⁸ As reflected for example in the Manulife case (O'Rourke 2002).

⁵⁹ See for example O'Rourke (2002) and Schwarz (1999) on the Texmaco case.

More fundamentally, endorsement of reforms can be particularly uncertain when there are changes in the very nature of the political decision process. For example, the Program was designed for an Indonesian environment characterized by a centralized administration where power resided with the president. However, with the fall of President Soeharto, the political decision process became far more complex and uncertain. The powers of the office of the president greatly diminished, while that of Parliament and other political actors or parties greatly increased. This created a fundamentally new environment for endorsing policy reforms, particularly as related to measures requiring legislation. As touched on in the next section, three of the four reform conditions in the Program that led to significant delays in implementation related to the requirement for new or amended legislation by a newly empowered Parliament.

These examples also suggest that endorsement and implementation of reforms are closely intertwined. Even if reforms are formally endorsed, as in the signing of LOIs, it may not be certain that they have the necessary political support. Often only when the implementation of reforms proceeds with clear and sustained political support can it be concluded that they have (or had) the necessary political endorsement in the policy decision process—*up to that point*.⁶⁰ The caveat is added, since reforms can be reversed even after implementation, as for example in the case of the restoration of subsidies, previously removed.

Lagging implementation and reversals of reform measures under successive presidents and changes in the political decision process indicate that endorsement of reforms is a dynamic process, as distinct from a discrete event. There are a number of points where the IFI reform program was endorsed formally, but in practice, at no point was this endorsement *complete*, i.e., explicitly involving all reform measures; or *binding*, i.e., sufficient to ensure that the reform program may not be modified or even reversed at a later stage in the policy reform process. Yet the implementation of policy reforms nonetheless could and did proceed, as will be discussed in following section. The implication is that the “endorsement of reforms” is an ongoing activity throughout the policy reform process, including and even beyond implementation.

E. Implementation

1. Overview

Operationally, as noted earlier most of the specific measures of the Program were implemented to a large extent independently of the complexities and recurring difficulties of the relationship between the government and the core of the reform package. In this context, given that Program design took place over a very short interval under conditions of uncertainty, complexity, limited information, and rapid change, to a large extent it has stood the test of time and events.⁶¹

⁶⁰ It should be noted that political support is necessary but not sufficient for effective implementation of reforms. Institutional capacity and commitment at the implementing agency level is also essential.

⁶¹ In some cases the relevance of particular measures was reinforced by subsequent developments. For example, condition 24.4 (“legislation to prevent money laundering”), which was delayed significantly, was initially seen as a peripheral measure aimed at combating corruption in Indonesia. However, following 9/11, it took on special importance in the context of combating the financing of international terrorism.

The issues identified were for the most part ones that continue to be important in terms of the Indonesian economy; and the Program has made important contributions to assist the government in addressing the crisis (for example, assessment of the financial status of banks as a precondition for restructuring and recapitalization), as well as to key longer-term reforms to strengthen the foundations of the Indonesian economy (as through bank and corporate financial disclosure). Implementation problems requiring modifications to Program design have been relatively limited under the circumstances, as reflected in the ADB's internal review (the Program Completion Report),⁶² especially given the comprehensive scope and large number of reform measures of the Program. However, there were extensive delays in implementation due to political and institutional constraints.

Outputs under the Program can be grouped into four broad areas (i) bank restructuring, (ii) adoption of best financial governance practices, (iii) increasing disclosure and transparency of financial information, and (iv) strengthening the legal and regulatory framework of the financial sector. As reflected in ADB's internal review, the Government of Indonesia implemented almost all of the policy conditions over the period covered by the Program.

There were two outstanding conditions not met at the time of third tranche release and closing of the Program—one related to the establishment of the SMF,⁶³ and another related to the enactment of legislation establishing liability for auditors and directors for negligence or fraud in the conduct of their duties.⁶⁴ The condition related to establishment of the SMF was waived as a consequence of two key factors that emerged during Program implementation. One, under a new Banking Law enacted in 1999, BI could no longer hold the required equity position in the SMF. Two, the depth of the crisis and its impact on banks and on general business conditions greatly constrained the interest and ability of other potential shareholders to participate in the SMF.⁶⁵ The condition related to enactment of legislation establishing liability for auditors and directors was carried over into ADB's subsequent Financial Governance and Social Security Reform Program, partly as a consequence of a changing political and legislative environment in postcrisis Indonesia, which emerged during Program implementation.

The implementation of the Program was delayed significantly, with final disbursement on 5 July 2002, approximately 48 months after loan effectiveness and initial disbursement; as compared with the original planned closing date of 31 December 1999. The delays were largely due to political economy factors: political and institutional changes and constraints. As noted, Program implementation took place in an environment characterized by deep economic crisis, accompanied by social instability, and political uncertainty and change. For example, there were rapid changes in the government at the political and policy levels—four presidents from Program design through implementation, with transition from a highly centralized system with a powerful president to a more pluralistic system and increasingly active Parliament—and changes at the level of senior officials involved with key Program measures (namely four IBRA chairmen in 2 years; changes in directors general in the Ministry of Finance).

⁶² For ADB's internal assessment of Program implementation, see Asian Development Bank (2003).

⁶³ Condition 6.4: "Government to establish a secondary mortgage facility." (Refer to the policy matrix in Appendix 1.)

⁶⁴ Condition 16.1 "Enact legislation/regulations making (i) auditors liable for negligence in performing audits, and (ii) directors liable for false information contained in the annual report and any other public information, liable for all board decisions." (Refer to the policy matrix in Appendix 1.)

⁶⁵ The case of the SMF raises interesting issues related to the design process, discussed in Appendix 2.

The institutional framework for Program implementation also changed in important ways. For example the Bank Law enacted April 1999 during Program implementation transferred core supervisory and regulatory roles of BI to a new institution called Otoritas Jasa Keuangan (or OJK, Financial Service Authority), affecting a number of Program conditions. The Bank Law also removed BI's ability to participate in the planned SMF. In addition, as will be touched on in Section IV, key activities in the policy matrix (restructuring plans for banks, corporate debt restructuring, study of the public provision of services) turned out to be far more complex and time-consuming than anticipated. Others involved an interplay of politics and economics that greatly delayed their implementation, such as the asset disposal by IBRA).⁶⁶ Within this context, the implementation schedule had to be modified several times, while maintaining the general integrity of the Program.

The initial timetable was adjusted just prior to approval, partly in response to a fundamental political changeover from President Soeharto to President Habibie following the violent May 1997 riots that put all stabilization efforts on hold, including the IMF review and planned disbursements.⁶⁷ The release of the second tranche was further delayed by several months in part by the generally deteriorating environment in 1998 (when the economy contracted by over 15% late in the year, and hyperinflation was a serious threat); as well as by Program-specific developments such as needed adjustments to Program measures when financial review of banks unexpectedly revealed that the majority were technically insolvent.⁶⁸

The extensive delays of the third tranche release also related to a large extent to political economy factors. At the macro level, the Habibie presidency was rocked by the Bank Bali scandal⁶⁹—leading to suspension of the IMF dialogue; and by growing unrest and violence in East Timor. In October 1999 President Wahid formed a new government. In this environment, at the level of the Program, as of ADB's progress review in February 2000,⁷⁰ there remained 4 outstanding conditions for third tranche release. Three of these measures related to the enactment or amendment of legislation in an increasingly complex political environment where Parliament was playing a far stronger and more active role with respect to legislative review and approval than anticipated at the time of Program design and approval. The fourth condition related to the establishment of the SMF, which was no longer seen as relevant or feasible. The three legislative conditions were sufficiently complied with for the third tranche release on 5 July 2002, with the fourth remaining condition relating to the SMF waived, as noted above.

⁶⁶ Two examples will suffice: Condition 1.6: "Resolution of insolvent banks" (third tranche release condition). This resolution of insolvent banks was related to the closing of these banks and disposal of their assets through IBRA. This took considerably longer than expected reflecting the complexity of the task, capacity constraints of IBRA as a newly-established special purpose institution, and political complications (declaration by President Wahid to protect selected large bad debtors). (Refer to the policy matrix in Appendix 1.)

Condition 1.7: "Develop and reach agreement on restructuring plans for all solvent commercial banks that do not meet the minimum CAR of 8% of risk-weighted assets. Plans to contain time-bound actions for improving the CAMEL rating to sound (sheaf)" (3rd tranche release condition). This activity was completed, as required, but took much longer than expected. The delays related to the complexity of task; capacity constraints of both banks and related-government agencies; and political complications ("preferential treatment" of selected banks, including in the channeling of BI recap funds). (Refer to the policy matrix in Appendix 1.)

⁶⁷ See Addendum 1 to Document R62-98 (ADB 1998a).

⁶⁸ See "R224-98, Loan 1618-INO: Progress Report on Release of Second Tranche" (ADB 1998b).

⁶⁹ This involved payment by Bank Bali of a 60% commission to a firm linked to the ruling party, Golkar, to recover interbank loans from IBRA, seen by many to have contributed to ending Mr. Habibie's presidency. See for example O'Rourke (2002).

⁷⁰ See "R224-98, Loan 1618-INO: Progress Report on Release of Second Tranche" (ADB 1998b).

2. “Nominal Reform” vs. “Implanting Change”

In general, significant steps were taken under the Program toward reform in the financial sector. Viewing policy reform as an extended process of implanting change, however, gives a more cautious perspective on the effectiveness of the implementation of reforms under the Program.⁷¹ For example, the legal and judicial framework for the financial sector was strengthened through amendments to the Bankruptcy Law, including adjustments to the judicial system such as establishment of commercial courts. However, in practice, real reform of the legal and judicial system is an ongoing challenge, as illustrated by difficulties in enforcing bad debt resolutions through the court system.⁷²

Similarly, a wide range of rules and regulations relating to the financial sector have been rewritten in a number of areas under the Program, for example, covering brokers and fair trading on the Jakarta Stock Exchange. However, the effective implementation and enforcement of codes, regulations, and laws initiated under the Program so they lead to actual changes in behavior remain a continuing challenge. At the same time, some of the measures implemented have not been clearly translated into reform actions. For example, the audit of SOEs was an important contribution of the Program, but the actual impact of these audits on real SOE reform is not clear.

F. Sustaining Reforms

Reforms implemented under the Program have initiated and/or effected important changes in financial sector governance. In general, these relate to strengthening the formal institutional and regulatory foundations for financial sector governance. In this context, many of the measures implemented under the Program have involved changing and/or enacting more effective rules, regulations, and legislation as those related to capital market supervision and financial disclosure.⁷³ In order to sustain reforms initiated under the Program, the key challenge is operationalizing and enforcing codes, rules, regulations, and laws so that they lead to changes in incentives and behaviors by banks and corporates.⁷⁴ Given problems of enforcement in the financial/banking sector prior to the crisis, this will require strong political support, continuing attention, and appropriate institutional capacity. The difficulties of implanting real change in the judicial system, touched

⁷¹ On this, see Abonyi (2002), also Abonyi (2005a and 2005b).

⁷² Strengthening the Bankruptcy Law and changes to the judicial system notwithstanding, in practice, a series of court decisions (against creditors, in the case of Asia Pulp and Paper, Jakarta Stock Exchange Complex, and Manulife) have undermined the credibility of the system in the eyes of the international investment community.

⁷³ See Appendix 1 for details in the policy matrix. Examples include:

Condition 5.1: “BAPEPAM to issue rules defining procedures and responsibilities for enhanced market surveillance by stock exchanges.”

Condition 5.2: “BAPEPAM to require and approve fair trading practices on stock exchanges.”

Condition 18.2: “Review and amend legislation/regulations to make financial disclosure, regulation, and enforcement consistent with international best practices.”

Condition 19.1: “Issue regulations requiring the filing and public accessibility of audited financial reports of corporations with total assets of Rp 50 billion and above; issue a decree on full disclosure of financial performance of the above corporations.”

⁷⁴ As the earlier review of the financial/banking sector indicates, there were rules and regulations in place prior to the crisis whose enforcement could have reduced the vulnerability of the sector.

on earlier, is an example of the challenges of transition from reforms as changes in rules, to inducing and sustaining real changes in incentives and behavior.

There are clear indications of continuing government commitment to reforms initiated under the Program. In December 2003 the IMF-supported program in Indonesia, which provided the framework for ADB's Program, came to an end. However, in September 2003 the government introduced the *Economic Policy Package Pre- and Post IMF* generally referred to as the White Paper (Government of Indonesia 2003) in part to signal its general commitment to implement and sustain key reforms initiated under the IMF-led program, as reflected in the various LOIs, relating to strengthening the financial sector. Under the White Paper a number of important measures that signal sustainability of reforms has been initiated—but will continue to require political support and institutional change for effective implementation and long-term sustainability.

A core area of reform relates to the establishment of an integrated financial sector regulatory and supervisory agency, OJK. This is intended to respond to past weaknesses that contributed to the crisis, including regulatory fragmentation, lack of independence, and insufficient resources; as well as to emerging challenges resulting from changes in the financial sector including a shift in the focus of banks to new types of lending, and expanding scope and blurring of boundaries of the activities of both banks and nonbank financial institutions or the "financial conglomerates" or "universal banking system." Under the White Paper, a Draft (financial service or OJK) Law has been prepared and sent to Parliament. Once the Law is passed, the establishment of OJK raises a number of institutional challenges for the government, including capacity building for the new organization to ensure its effectiveness; and issues of coordination with core agencies, in particular BI and Ministry of Finance.

The closing of IBRA at the end of April 2004, after an uneven history marked at various times by political and institutional uncertainty and constraints, finally signaled the successful resolution of the problem of the crisis-induced overhang of nonperforming loans.⁷⁵ However, continuing challenges of sustainability related to gains in the banking sector remain. Fundamentally the banking sector is still dependent on the crisis-induced government blanket guarantee, which continues to provide a protective umbrella for the financial sector. Revoking the blanket guarantee and replacing it with a deposit insurance scheme will be the key signal that the crisis is truly over, and that the financial sector is on a sustainable footing. In this context, under the White Paper, another Draft LPS Law (deposit insurance) Law will provide the foundations for a financial safety net.

A key constraint on the sustainability of reforms and recovery from the crisis relates to the health of the corporates and their relationship to the financial sector/banks—an issue not sufficiently recognized at the onset of the crisis, as noted. As of the end of 2004, banks awash with liquidity of around Rp 190 trillion, or about 10% of the economy, were not yet prepared to lend to corporates. They preferred to keep their assets in the form of government bonds, central bank discount bills (SBI)—which together account for almost 40% of the banks' interest income—and consumer loans regarded as less risky than corporate lending (*Jakarta Post* 2004). To a large

⁷⁵ In the end, IBRA recovered around 28% of the face value of the assets it held, approximately the same rate as in Korea.

extent, bank lending is constrained by perceptions of continuing problems of large corporates—although there is a view that banks are being overly cautious. Therefore effective implementation and sustainability of corporate governance and financial disclosure reforms in the corporate sector—a function, in turn of the institutional strengthening of key institutions such as the commercial courts and BAPEPAM (the capital market supervisory agency)—are a key prerequisite for restoring the health of the financial sector.

In sum, sustainability of reforms initiated under the Program is fundamentally a function of continuing political support and institutional capacity to implement change. These core political economy factors that shape the policy reform process are the focus of the next section.

IV. BUMPS ON THE ROAD TO REFORM: POLITICS AND INSTITUTIONS

A. Introduction

Political acceptability and institutional feasibility play a central role in shaping reforms throughout the policy process. It is this role of politics and institutions that transforms the reform process from an exercise in technical problem solving, or “optimal policy design”, into a long-term and uncertain process change shaped by political economy factors. Building on the discussion of the policy reform process, this section examines the Program, within the context of the IMF-led IFI package, from the perspective of role of politics and institutions. These factors are also key sources of uncertainty and risk with respect to “government commitment”, the assumed guarantor of reform in policy-based lending. This section concludes by looking briefly at the concept of “government commitment” from a political economy perspective with respect to the Program.

B. The Politics of Policy Reform⁷⁶

Policy reforms are inherently political in nature, entailing a process of collective choice. That is, reforms are “political” in that they involve: (i) multiple interests or stakeholders; (ii) with differing perceptions; (iii) conflicting preferences; (iv) diffusion of power to influence outcomes; and (v) no easy way to align diverse and conflicting preferences.⁷⁷ Therefore policy reform as politics requires some process of mutual adjustment among diverse and conflicting stakeholders, which involves negotiation, bargaining, and consensus building that shape, can modify, or even block reforms at any point in the policy reform process. In general, “political acceptability” can play an important role in influencing any stage of the policy reform process, from inception through implementation and sustainability. Selected issues related to the Program then illustrate ways in which politics can relate to the policy reform process.

⁷⁶ See also Abonyi (2002) and (2005).

⁷⁷ For a discussion of this issue, see Abonyi (1986).

1. Political “Ownership”

The concept of “political ownership” of policy reforms means that a coalition of stakeholders supports a set of reforms (or prefers them to the status quo); *and* has sufficient power within the context of the existing institutional framework to ensure that these reforms are placed on the policy agenda, endorsed, implemented, and sustained. This can involve a particular set or package of reforms (as the first LOI) or specific reform measures (as the closing of the 16 banks). It is important to stress that having preferring a set of reforms is necessary but not sufficient, and that power is needed to ensure that these reforms work their way through the policy process. In the case of the Program, within the wider context of the IFI package, political ownership of reforms was uncertain from the outset, and changed over time. Similarly, effective support of successive presidents for the reform agenda was uncertain and fluctuated over time (for instance, the Bank Bali scandal under President Habibie; President Wahid’s interference in IBRA’s restructuring decisions). Furthermore, stakeholders with the interest and power to modify or block particular reforms were able to do so at various times in the process, as when they contested the closure of a bank; misappropriation of BI’s financial support (BLBI) to banks;⁷⁸ and structural reforms such as dismantling APKINDO, the plywood cartel (Kenward 2002). In addition, as noted earlier, there was uncertainty even with respect to the support of reform-minded senior technocrats for including certain measures such as real sector restructuring on the policy agenda at a time of deep crisis. Therefore “political ownership” of reforms means building and maintaining a pro-reform “winning coalition” of interests over the various stages of the policy reform process.

2. Political Transition and Uncertainty

Given the rapidly changing political environment, support for the reform agenda could not be taken for granted as the social and political environment evolved in the context of deepening economic crisis. Political support for reforms had to be continually reaffirmed and renegotiated. For example, the succession of four presidents (Soeharto, Habibie, Wahid, and Megawati) over the life of the Program meant that support for the reform agenda was uncertain with each changeover. The uncertainty with respect to President’s Soeharto’s position has been discussed earlier. President Habibie’s position was initially perceived as even more uncertain, given that in his earlier role as Minister for Research and Technology under President Soeharto, he had taken an approach to economic policy that was fundamentally at odds with the general advice of the IFIs over the years.⁷⁹ Yet after becoming president, he generally supported an economic reform agenda, with qualifications (the Bank Bali scandal). Presidents Wahid and Megawati came to power with little experience in government, and with limited knowledge of their likely approach to economic management. Their tenure reflected uneven support for and capability to undertake reforms. More fundamentally, after 32 years of rule by a powerful president, the shift to a *de facto* different, more pluralistic political

⁷⁸ See Appendix 3. See also for example O’Rourke (2002).

⁷⁹ Briefly, Minister Habibie’s basic idea was the need for the government to select and support high-value, technology-based strategic industries as the basis for economic growth and development. This raised issues about the role of government in the economy, and about public finance. See for example Schwartz (1999).

decision system injected a more fundamental uncertainty into reform decisions (see below). In addition, the evolution of the IFI reform agenda from the first to the second LOI raised the political content, and therefore politically uncertainty, related to policy reforms.

3. Systemic Change in the Political Decision Process

As noted earlier, Indonesia underwent fundamental changes in the policy decision system during the life of the Program. Designed for an environment dominated by a centralized administration led by a powerful president, the Program found itself in a world where the power of the Office of the President was greatly diminished while that of Parliament and other political actors and parties greatly increased. This environment was characterized by greater participation in decision making by a larger and shifting set of stakeholders with differing perceptions, interests, and power. The concept of “political ownership” was more complex in this new environment, and related to the stability of coalitions of a larger number of stakeholders participating in a still evolving political decision process. The political and policy decision environment was therefore increasingly characterized by uncertainty as to process, time, and outcome, particularly as related to reforms requiring Parliamentary scrutiny and approval. The implications of this systemic change are reflected, for example, in the extensive delays associated with measures in the Program involving new or changed legislation.

4. Bureaucratic Politics

In addition to “high level” politics, an important factor in policy reform relates to bureaucratic politics associated with the preferences, behaviors, and relative influence of particular organizations involved in the implementation of reforms. Implementing agencies through their actions can modify or even block the implementation of political policy decisions. This injects another source of uncertainty into the reform process. For example, under the second LOI the government agreed and issued a Presidential Instruction to prohibit *retribusi* (local taxes) on export goods. However, these instructions were ignored at the local level, where for example officials in the districts said that they received no such instructions from their provincial-level supervisors (Kenward 2002). Similarly, there are important differences in perspective among some elements within BI and the MOF with respect to the establishment and expected role of OJK, the planned financial sector supervisory agency, whose effectiveness will depend on close cooperation with both these institutions.⁸⁰

5. IFI Politics

There were differences among the IFIs in approaching support to the government for the reform process. As noted, the fundamental difference between the IMF and ADB with respect to

⁸⁰ From interviews with senior officials in the Government of Indonesia and the IFIs.

the establishment of IBRA resulted in significant delays to the Program. There were also differences between the World Bank and ADB with respect to defining the scope of their respective programs supporting reform in the banking sector.⁸¹ Therefore although there may be continuous pressures (by donor countries) for IFI “harmonization” in policy dialogue and policy-based lending, basic differences in approach and interest are likely to arise among different IFIs in supporting policy reform. These may stem from “bureaucratic politics” involving competition with respect to relative power and influence with recipient governments, or from differences in perspective with respect to substantive policy reforms.⁸²

C. Institutions: Shaping and Implementing Change⁸³

Policy reforms are fundamentally “institutional” in nature. This involves: (i) institutions as “rules of the game”: property rights, workings of the political system, judiciary, bureaucracy; and (ii) institutions as organizations: implementing policy reform activities.⁸⁴ Institutions relate to policy reform in two ways:

- (i) they influence the policy process (framework for how issues get on the policy agenda; decision making process on policy reforms such as the passing of legislation, program design) and therefore the shape of planned reforms; and
- (ii) they help determine the outcome of reforms (output of the activities of implementing agencies). In this context, institutional capacity, including the capability for different agencies to work together, conditions the implementation of reforms. Furthermore, an important objective of reform may be modification of the existing institutional context both as “rules of the game” and as organizations. Selected issues related to the Program then illustrate ways in which institutions can relate to the policy reform process.

1. Institutions as “Rules of the Game”

The Program was conditioned by a changing institutional environment, and at the same time involved reform measures intended to change the “rules of the game” for the economy. As discussed, fundamental changes in the political and policy process reshaped the policy agenda and the endorsement of reforms, and were a key source of uncertainty and delays in the reform process. In addition, the Program, and more broadly the IFI reform package, was aimed in part at changing the institutional foundations of economic management. In this context, a key focus of reforms was to change the judicial system and regulatory framework as related to the financial and corporate

⁸¹ The ADB expressed a strong interest in involvement with the review of some core private sector banks. However, these were included only in the WB program, within the overall IFI framework (from interviews).

⁸² In the case of the IMF–ADB differences over IBRA, there are indications that there were fundamental differences in perspective, but that “IFI politics”, including the role of particular personalities, also was a factor (based on interviews with senior officials of the IFIs and the government).

⁸³ See also Abonyi (2002) and (2005a and 2005b).

⁸⁴ The first meaning corresponds to the use of the term in “the new institutional economics”, e.g., Williamson (2000). The second meaning corresponds to the traditional use of the term in the management literature.

sectors, seen as key sources of problems contributing to the crisis—with as yet uncertain outcomes.⁸⁵ Similarly, many of the measures were aimed at changing the bureaucratic institutions related to the financial sector (e.g., BI, BAPEPAM).

2. New Institutions/Organizational Change as Source of Uncertainty and Risk

Policy reforms often involve the creation of new institutions, and/or the extensive redesign of existing institutions. Although this may be an important part of the reform process, new institutions and institutional redesign involve significant uncertainty and risks (Smith 2002). As noted earlier and discussed in greater detail in Appendix 4, a new institution, IBRA, was created to oversee rehabilitation and restructuring of the banking sector, including the resolution of bad debts (as well as implementation of the blanket loan guarantee scheme). The very wide scope and complexity of IBRA's mandate made extensive demands on the capabilities of the new organization—and was a significant source of uncertainty and delays in the implementation of reforms. For example, as discussed in Appendix 4, the implementation of condition 1.6 of the Program, “the resolution of insolvent banks”, took considerably longer than expected, reflecting the complexity of the task coupled with capacity constraints on IBRA. In addition, political interference (e.g., protection of selected large debtors) in the functioning of IBRA became an important source of delay, constraints, and uncertainty for implementing agencies in the policy reform process. It should be noted that the establishment of OJK, the planned umbrella regulatory agency for the financial sector, also faced important and uncertain challenges in its start-up and operations. Similarly, redesigning or changing existing organizations is an uncertain and risky process. For example, studies have found that the average success rate is about 30% across all types of organizational change, and drops below 20% when culture is involved. A wide range of reforms under the Program involved organizational change (to BI, MOF, BAPEPAM, BPKP; see policy matrix in Appendix 1).

3. Institutional Capacity Constraints

Capacity constraints on existing institutions contributed to both the onset of the crisis, and constrained the implementation of reform measures. As noted, the inability of BI to effectively monitor the state of the financial/banking sector and enforce existing regulations was a key source of problems leading to the crisis. At the same time, weak institutional capacity constrained the implementation of reforms. For example, preparation of restructuring plans for solvent banks that did not meet minimum capital asset ratios of 8% (condition 1.7) took much longer than expected, in part because of capacity constraints of both banks and related government agencies. Political constraints on implementation, in the form of preferential treatment of well-connected banks, were

⁸⁵ Examples include Condition 23.1: Review the legal and institutional framework for debt recovery, including the establishment of an arbitration system, and prepare and action plan”; Condition 24.1: “Enact laws to provide a legal and judicial system of arbitration to address private commercial disputes”; Condition 24.2: “Revise laws and regulations on bankruptcy and secured transactions”. See the details of the policy matrix in Appendix 1.

also a factor. Restricting BI liquidity support [BLBI] to sound banks for limited (temporary) periods at market rates (condition 2.3), although considered by ADB as complied with, turned out in practice to be problematic, as discovered later, because of the inability of BI to monitor and prevent the widespread and flagrant misuse of most of the BLBI funds, with continuing impact on the Indonesian economy and public finance. As a further example, condition (10.3) requiring the MOF to undertake a comprehensive study on the public provision of services was delayed significantly because the complexity of the task strained the capacity of the institution.

D. Government Commitment: Stability of Expectations⁸⁶

Government is committed to guarantee that planned reforms will be implemented and sustained. Therefore government commitment provides a level of stability of expectations that reforms will be carried out more or less as planned, reducing risk and uncertainty for policy-based lending. The ADB approval document states that “the full commitment of Government and BI is therefore essential for the successful implementation of the Program.”⁸⁷ This is in the section entitled “Risks and Safeguards” and aptly so, since changing government commitment is a key, proximate cause of risk in reform and policy-based lending.

More deeply, behind government commitment as a potential source of risk to policy reform and policy-based lending, it is the political economy factors of politics and institutions that are the continuing source of uncertainty and risk. Government commitment can be subject to change at any point during the policy reform process, as new political pressures come to bear, or as constraints on institutional capacity to undertake reforms emerge. Therefore a better and earlier appreciation of the potential role of politics and institutions in the policy reform process can provide important information on likely sources of uncertainty and risk to continuing government commitment, and therefore to policy reform and policy-based lending.

In this context, shifts in, or perceived lack of government commitment to reforms may arise from fundamentally different factors, with widely different implications.⁸⁸ This is reflected in the case. Uncertainty in government commitment may be the result of lack of intent to implement reforms, as in the case of President Suharto’s presumed limited commitment to the IMF-led reform agenda. Alternatively, the intent to reform may be there, but the capacity to implement reforms may be limited, as in the case of the implementation of reforms by IBRA, BI, or MOF. Or there may be basic differences among stakeholders’ understanding and preferences with respect to the nature of the reforms, constraining the government’s ability to proceed. This was the case in the delay in the enactment of legislation/regulations involving the liability of auditors (condition 18.1) arising in part because of differences among key stakeholders over who should govern the accounting profession, the government or the profession itself.⁸⁹

⁸⁶ Also see Abonyi (2002 and 2005).

⁸⁷ See “RRP: INO 31660” (Asian Development Bank 1998c).

⁸⁸ For a more detailed discussion see Abonyi (2002), especially Annex 3.

⁸⁹ From interviews with key participants.

V. CONCLUSION: IMPROVING THE ODDS

A. Introduction

The “bumps along the road to reform” were to a large extent the result of the political economy factors conditioning the policy reform process: the role of politics and institutions. The concluding question then is what general lessons may be drawn from the case with respect to the political economy of reform that can be applied, if not to remove the ever-present bumps to policy reform, then at least allow for more effective ways of navigating around them. That is, how can the odds be improved for design and implementation of reforms, and in particular, support of policy-based lending, so that they are both relevant and feasible in facilitating the reform process.

B. Lessons Learned⁹⁰

The lessons from the case may be grouped into three general categories relating to: (i) preconditions for effective policy reform and policy-based lending, (ii) role of politics in the policy reform process, and (iii) institutional feasibility of reforms. These lessons are likely to be relevant to both governments and external donors (IFIs) involved in the policy reform process.⁹¹

1. Preconditions for Effective Reform and Policy-based Lending

(i) Scope of the Policy Reform Program and Related Diagnosis

Program design defines the scope and focus of reform, and sets both its political and institutional boundaries. Given the complexity of policy issues, defining program scope and focus—what to include and exclude, where to concentrate attention and resources—is a balancing act that requires effective diagnosis of the policy issue(s) and of potential leverage points where reform initiatives can make a difference.⁹² In the case of the IFI-led package in general, and the Program in particular, there was insufficient attention given to the problems of the corporates and their critical implications for the financial sector. That is, the policy issues and therefore corresponding reform measures were defined too narrowly. This continues to pose significant constraints on restoring the health of the financial sector/banks, as well as of the corporates, contributing to a continuing fragility of the foundations of the Indonesian economy. Yet while doing too little may be a problem, doing too much may be equally problematic. The case suggests that overloading the policy matrix, especially under crisis conditions, is likely to be counterproductive if it exceeds the absorptive capacity of the government in terms of resources, policy attention, institutional capacity, and political support. It is likely to lead to delays, implementation problems, and necessary

⁹⁰ These are meant to be general lessons related to policy reform.

⁹¹ See Abonyi (2002), particularly for implications of political economy factors for donors such as ADB.

⁹² See Abonyi (2002) for a discussion of the complexity of policy issues and its implications.

modifications of reform measures. It is now generally recognized that the inclusion of extensive structural conditionalities in the IMF-led IFI adjustment and reform package (the second LOI) led to just such problems.⁹³ In the case of the Program, including the SMF provides an illustration. In sum, proposed programs of reform must be carefully scrutinized for both *relevance* and *feasibility* at the design stage.

(ii) Timetable for Reform

Implementing and sustaining policy reforms involves a complex, uncertain, and long-term process of change. This is likely to be particularly challenging in the context of a deep crisis when the political and institutional environment is changing in fundamental and uncertain ways. Building stable coalitions for supporting proposed reforms (potential “reform winners”), particularly when they address sensitive issues with strong existing constituencies (potential “reform losers”), is likely to require time. Similarly, strengthening existing organizations, (e.g., BI, BAPEPAM, BPKP) through extensive organizational change is likely to be a complex, long-term process; and creating new organizations/institutions (IBRA) is likely to be even more challenging and uncertain. Therefore the time needed for policy reform through Program implementation must accommodate building the necessary political consensus for particular reform measures, as well putting in place institutional capacity needed for implementing such reforms.

(iii) Crisis as a “Window of Opportunity”

As the case demonstrates, a crisis can create conditions needed to initiate reforms or address key problems in the financial sector. That is, a crisis provides a window of opportunity for addressing needed reforms that may be far more difficult to put on the policy agenda when there is no sense of urgency for change, as with addressing the problems of nonviable banks and corporate governance issues. However, unless the necessary political and institutional support can be put in place for sustaining reforms over the longer term, when the crisis recedes, so may the reforms. In terms of the Program, corporate governance-related reforms, as well as reforms of the judicial system are examples of complex changes likely to require further reinforcement and support to be sustainable. Reform-through-crisis raises a further basic issue: to what extent should a program in a deep crisis setting such as Indonesia, incorporate reform measures involving structural and institutional changes that are relevant over the longer term, but are less direct in their impact and less urgent in the context of the crisis, both in terms of its basic causes, and in terms of restoring stable growth? As reflected in the case, care should be taken in using crises as “windows of opportunities” for reform. Peripheral issues can distract scarce policy attention and resources in a deep crisis. Structural reforms in the IFI package, and the SMF in the Program provide examples.

⁹³ See IMF's Independent Evaluation (IMF 2003).

(iv) IFI Coordination vs. Harmonization in Supporting Policy Reform

In general, policy and institutional reform is more an art than a science. It is often characterized by limited understanding of key policy issues and of institutional change in diverse settings; and therefore uncertainty as to what may be the most effective way to proceed in differing country settings. There are often equally relevant alternative approaches to the same set of issues; and/or the same basic approach may differ significantly in requirements for implementation in different settings. The establishment of IBRA is a case in point. There are alternative approaches to debt restructuring, such as creation by government of a central agency such as IBRA, or using market-based approaches for banks to directly address the problem. Therefore IFI cooperation may often best serve the interests of the countries through coordination of different “experiments” at policy and institutional reform (and associated learning), rather than harmonization of “one best way.”

(v) Political Acceptability

a. Assessing political acceptability: Feasible reforms require support from stakeholders with an interest in such reforms, and the political power to ensure that these reforms are placed on the policy agenda, endorsed, implemented, and sustained. In the case of the Program, within the wider IFI framework, there were key gaps and uncertainties in the political acceptability of core reforms. As a consequence, reforms were at times inadequately implemented, not implemented, reversed after implementation, or not sustained. Therefore a key requirement for effective reforms and supporting policy-based lending is to assess the political acceptability of proposed reforms with key stakeholders and coalitions likely to support particular reforms; and with stakeholders likely to attempt to block such reforms, and under what conditions.⁹⁴ This is not a one-time issue. As the case illustrates, political support for reform is likely to fluctuate over time. Therefore assessing political acceptability is an ongoing process, particularly when there are key changes in the Program environment (in government), in key personnel, in the composition of political coalitions, and systemic changes. In this context, part of the assessment of political acceptability needs to involve an analysis of bureaucratic politics. As reflected in the case, implementing agencies are also “stakeholders” in the reform process, and may have the incentive and the power to modify or even block the particular reform measures.

b. Promoting public awareness and coalition building: There was limited public understanding of the role of key reforms addressing complex problems as with financial sector restructuring, and the credibility of proposed reforms in the face of vested interests was suspect. This was particularly the case in the context of a deep crisis, and a lack of “history” with related reforms in Indonesia exemplified by the unprecedented closing of the 16 banks in November 1997. Therefore as reflected in the case, a key requirement for feasible reforms is to promote public awareness and understanding of both the nature of the policy issues and the required policy responses (reform measures), in order to build the necessary stakeholder coalitions for supporting policy reforms. This is particularly important in the face of a crisis of confidence—the context for the Program in Indonesia—where it is essential to restore faith in economic management.

⁹⁴ See Abonyi (2002) on this issue.

c. Relationship between the specific reform Program and the wider political system: The Program was designed and implemented during fundamental changes in the political decision system in Indonesia. As noted, the implicit assumption in Program design was of a centralized system, with power concentrated in the Office of the President. By the time of Program implementation this was no longer the case, with a pluralistic Parliament increasingly asserting itself in the policy decision process. As a consequence, key sources of delay in Program implementation related to reforms that involved legislation and required Parliamentary approval. Therefore an important requirement for effective reform implementation is to ensure that the assumptions embedded in Program design with respect to the policy decision process continue to be valid over time.

(vi) Institutional Feasibility

a. Assessing institutional feasibility of proposed reforms: As the case illustrates, policy reforms are generally “institution-intensive”, requiring institutions/organizations that are both capable and willing to implement such reforms. Therefore a key challenge in designing feasible reforms is to assess the institutional requirements for implementation, and to ensure that the necessary organizational capabilities are in place.⁹⁵ Unless there is an appreciation of the institutional feasibility of planned reforms at the design stage, there is a high risk that reforms may not be feasible, and/or that an organizationally overambitious reform program may result. If institutional analysis reveals significant gaps between existing and required capacity, then either the program design needs to be adjusted, or the capacity of implementing agencies needs to be strengthened. In the case of the Program, within the larger context of the IMF-led IFI framework, institutional constraints played an important role in limiting the implementation of reforms. For example, IBRA experienced significant constraints in implementing core financial sector reforms, especially in the early stages of bank restructuring and asset disposal. Similarly, constraints that emerged on BI’s capabilities during the reform process were a key reason for moving the supervision function out of BI and the planned establishment of OJK—whose capacity and coordination requirements, in turn, were equally challenging. The implementation of various reform measures under the Program, for example by BAPEPAM and MOF, also turned out to be substantially more challenging than anticipated. Therefore policy reform is fundamentally about ensuring that institutional capacity is in place, which in turn, may require considerable time and resources, particularly if it involves significant changes to existing organizations and/or the creation of new institutions.

b. Participation of implementing agencies in Program design: Reform is ultimately about implementation. In this context, the institutional feasibility of program design can be significantly strengthened through participation of implementing agencies in the design process. In the case of the Program, key agencies responsible for implementing specific reforms, although consulted, were generally not core participants in the program design process, which involved primarily senior MOF officials along with the ADB team. As a consequence, unexpected institutional constraints on proposed reforms emerged during implementation, leading to significant delays, and in some cases, as noted, limits on effective implementation of reform measures. The implication is that it is important to involve line agencies responsible for implementing policy reforms in the design process to ensure

⁹⁵ See Abonyi (2002) on this issue.

that the proposed reforms are feasible, and that the implementing agencies understand and support such reforms.

EPILOGUE "RETHINKING CONDITIONALITY": AN ALTERNATIVE PERSPECTIVE

The effectiveness of policy-based lending has been the subject of ongoing debate since its origins in the early 1980s.⁹⁶ The discussion has often focused on the nature and role of conditionalities that set out the policy measures that must be implemented by a country borrowing from IFIs to support policy reform. As a consequence, the approach to policy-based lending and associated conditionalities has evolved over time. For example, there is an extensive review of conditionality under way by the World Bank (World Bank 2005); and the British government's Department for International Development (DFID) recently issued a fundamentally revised approach to conditionality and policy-based lending (DFID 2005). The purpose of this epilogue is to suggest the implications of this and related case studies (Abonyi 2005a and 2005b) for the ongoing debate. In this, it ventures beyond the confines of the particular case study to make more general observations.

At the risk of caricaturing the very rich discussion on policy-based lending and conditionalities, some of the emerging lessons are as follows: (i) policy reform, and therefore policy-based lending, is a difficult and uncertain undertaking for both governments and supporting IFIs; (ii) in this, policy reform is fundamentally a domestic process of change; (iii) therefore country ownership is critical to the success of reforms; and (iv) emphasis is increasingly on customizing reforms to the local country contexts as distinct from a uniform focus on generic "best practice" as the basis for policy reform in very different settings. The conclusion increasingly drawn from these lessons (Dollar and Svensson 1998, World Bank 2003, DFID 2005) is that policy-based lending should focus on outcomes and/or completed prior actions, not on reform-related intentions or promises of future action. The implication is that countries with good policies should receive support; those that have not demonstrated good policies should not.

The results of this and related case studies are consistent with the above lessons; however the implications for policy-based lending are seen somewhat differently. The stated assumption in focusing policy-based lending on countries that have demonstrated good policies is that "donors cannot 'buy' or induce reforms": countries have to own reforms, which is demonstrated either through the selection of "good policies" (World Bank 2003) or by achieving "good outcomes" (DFID 2005). Therefore according to this perspective, policy-based lending will/should be given if and only if the recipient country is already implementing donor-approved reforms. The implication is that countries that do not already have key domestic factors and a certain level of capabilities in place for formulating and implementing effective policy reform will not be helped by policy-based lending. That is, such lending and associated technical assistance can play little useful role in bringing

⁹⁶ Examples in the literature include Jayarajah and Branson (1995); Schadler et al. (1995); Dollar and Svensson (1998); Asian Development Bank (1999 and 2000); World Bank (2003, 2004, 2005); and DFID (2005). See Abonyi (2002) for additional references and discussion of this issue.

about the transition to “good” from “bad” or problematic policies; it cannot induce change, it can only help in maintaining what are “good” (meaning donor-approved) policies already in place.

This and related cases suggest a different perspective. It is not at all clear that there is an agreed upon standard for “good policies and institutions” in a variety of settings and circumstances, even if tailored or redesigned for local contexts. As experience of a diversity of *developed* economies shows, there is no one-to-one correspondence between a well-functioning market economy and a corresponding set of policies and institutions such as labor markets and state/public enterprises. Although there is a growing stock of knowledge about characteristics of well-functioning economies, and “international best practice” in selected policy areas, there is significant uncertainty and room for choice in the relationship between economies, policies, and institutions in particular settings (see for example Rodrik 2004, Nelson et al. 1997).

In this context, the perspective reflected in the case studies is that policy-based lending can indeed be more useful in supporting policy reform—even in countries that are not yet implementing “good policies” or that as yet have not achieved “good outcomes”—if it were approached differently. That is, policy-based lending can be more effective in contributing to a *process* of inducing policy change if the design and implementation of such programs better reflected the role of politics and institutions that condition the policy reform process. Therefore the focus of this and related cases is on how to better understand and accommodate political economy factors in the program design process in order to support policy reform more effectively. This is the thrust of the earlier section on “lessons learned.” For example, in the case of Indonesia, the challenge to policy-based lending was to provide critical and effective financial and technical assistance during a process of fundamental political-economic transformation.

In sum, launching reform is a bit like a “local earthquake”: it upsets not only the existing policy mix, but sets in motion over an extended time horizon, often unpredictable and unanticipated changes in structures, systems, processes, incentives, expectations, behaviors, relationships, power alignments, and institutions. This is further complicated in times of crisis and rapid change, as in Indonesia. Therefore policy reform requires a high tolerance for uncertainty and risk by both governments and donors. In this context, programs cannot be designed upfront with any certainty, however extensive the preparations. Policy reform and associated programs are thus more in the nature of an unfolding experiment, where expected outcomes or conditionalities are best seen as “working hypotheses.” In this context, the implication of the cases is that a better appreciation of the role of political economy factors in particular settings can perhaps help improve the odds for reform.

APPENDIX 1

FINANCIAL GOVERNANCE REFORMS SECTOR DEVELOPMENT PROGRAM POLICY MATRIX

Overall Objective: To improve the governance of financial and public sector allocation of resources through (i) the adoption of best financial governance practices in both public and private sectors, (ii) increasing the disclosure and transparency of financial information, and (iii) strengthening the legal and regulatory framework of the financial sector.

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
I. ADOPTION OF BEST PRACTICES				
A. BANKING 1. Restructure commercial banks to improve the soundness of the banking system	1.1 Closure of the 16 banks that did not meet prudential norms and could not be rehabilitated.	November 1997		
	1.2 Preparation of strategies for the recovery of assets of closed banks.	December 1997		
	1.3 Placement of all commercial banks with an unsound CAMEL rating under BI conservatorship.	December 1997		
	1.4 Undertake a financial review of commercial banks that have received substantial liquidity support from BI or have a low capital adequacy ration (CAR). These reviews to be undertaken by independent international accounting firms.		June 1998*	
	1.5 Undertake a financial review of all other commercial banks. These reviews to be undertaken by independent international accounting firms.			August 1998*
	1.6 Resolution of insolvent banks.			December 1998*
	1.7 Develop and reach agreement on restructuring plans for all solvent commercial banks that do not meet the minimum CAR of 8% of risk-weighted assets. The plans to contain time-bound actions for improving the CAMEL rating to sound (<i>sehat</i>).			December 1998*
	1.8 BI and the Indonesian Bank Restructuring Agency to enforce compliance with restructuring agreements.			Ongoing
	1.9 Eliminate restrictions on foreign shareholdings of listed commercial banks.			July 1998*
	1.10 Amend all applicable legislation/regulations to facilitate mergers and liquidation of commercial banks.		June 1998	
	1.11 Establish a Financial Sector Restructuring Committee to oversee restructuring of commercial banks and the financial system.	December 1997		

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
2. Increase market orientation	1.12 Establish procedures, systems, and structures to monitor implementation of banking sector restructuring		April 1998*	
	2.1 Eliminate all directed lending programs except those for small and medium enterprises (SMEs).	January 1998		
	2.2 Undertake a study of directed lending programs to SMEs.			December 1998*
	2.3 Restrict BI liquidity support/lending to sound banks, for limited (temporary) periods and at no less than market rates.	February 1998		
	2.4 Remove all geographic limitations on operation of banks.	February 1998		
3. Improve financial infrastructure	2.5 Divest all BI holdings in commercial banks as quickly as practicable, given market conditions.		Ongoing	Ongoing
	3.1 Convert clearinghouses to fully automatic operation and complete the setting up of Jakarta Electronic Clearing System.			August 1998
	3.2 Finalize plans and financing arrangements for implementation of the real time gross settlements system.		June 1998	
	3.3 Initiate the implementation of the real time gross settlements system.			December 1998*
4. Capacity building in the banking sector	4.1 Assess the desirability of establishing a deposit insurance scheme.			October 1998
	4.2 Establish an on-the-job inspection training program (both on-site and off-site) for supervision staff in BI	February 1998	Ongoing	Ongoing
B. CAPITAL MARKETS				
5. Develop an efficient capital market	5.1 BAPEPAM to issue ruled defining procedures and responsibilities for enhanced market surveillance by stock exchanges.		June 1998	

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
6. Promote the development of bond markets	5.2 BAPEPAM to require and approve fair trading practices on stock exchanges.		June 1998	
	5.3 Promote an efficient and liquid stock market by ensuring an adequate number of public shareholders and proper distribution of shares through a revision of Jakarta Stock Exchange rules.		June 1998	
	5.4 BAPEPAM to complete a study on the introduction of a risk-based capital requirement for securities companies consistent with international best practice.			December 1998
	5.5 BAPEPAM to issue rules defining risk-based capital requirements for securities companies to apply from 1 January 1999.		June 1998*	
	5.6 BAPEPAM to ensure (i) commencement of Clearing Guarantee Corporation; (ii) initiation of settlement guarantee, (iii) initiation of investor protection guarantee, and (iv) establishment of a clearing and settlement system for securities that is in line with the FIBV best practices.	December 1997	June 1998 June 1998	Ongoing
	5.7 Establish a central securities depository system to provide core depository services in line with accepted international practices, as outlined by the Group of Thirty, including the transfer of securities via book entry. BAPEPAM will (i) ensure that interim operations for centralized depository system commence, (ii) determine when central securities depository system will become fully operational.			December 1998 December 1998
	5.8 BAPEPAM to conduct a study on the feasibility of establishing a futures and options market for financial instruments.		June 1998	
	6.1 BAPEPAM to issue rules to provide the legal framework enabling the domestic issuance of asset-backed securities.	December 1997		
	6.2 BAPEPAM to prepare a bond market development plan; this will explore the potential of asset-backed securities to provide benchmark yield curves.			September 1998

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
7. Strengthen institutional investors	6.3 The Ministry of Finance (MOF) to issue a decree to provide the legal framework for the establishment and operation of a secondary mortgage facility.	February 1998		December 1998
	6.4 Government to establish a secondary mortgage facility.			
	7.1 Announce scheduled increases in the minimum capital requirements for all insurance companies from Rp5 billion applicable at the end of 1998 to Rp15 billion, applicable at the end of 2000.		June 1998	
	7.2 Announce new risk-based capital standards for insurance companies consistent with international standards.		June 1998*	December 1998
	7.3 MOF to facilitate the establishment of private pension funds through the introduction of simplified fund registration procedures.		June 1998	
	7.4 Amend legislation to enable life insurance companies to manage private pension fund assets.			
8. Capacity building of BAPEPAM	7.5 Undertake a comprehensive review of the pension system.			December 1998
	8.1 BAPEPAM to develop and implement a staff training program, including conducting a training needs analysis and developing in-house and external training courses to cover all aspects of BAPEPAM's operations, in particular, enforcement, accounting standards, management information systems, and computer skills training.		June 1998	Ongoing
	8.2 BAPEPAM to develop and implement a management information system implementation plan, addressing the introduction of computer operations in relevant areas, development and customizing of software applications, and establishment of a records management system.		June 1998	Ongoing

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
C. PUBLIC FINANCIAL MANAGEMENT				
9. Promote good governance	9.1 Review the Anti-corruption Act No. 3 of 1971 and study institutional and regulatory constraints on accountability and good governance.	February 1998		
	9.2 Recommend enactment of a decree acceptable to the ADB to strengthen the provisions of the Anti-corruption Act.		June 1998*	
	9.3 Formulate a comprehensive anticorruption strategy using competition to the maximum extent possible in both public and private sector operations.			November 1998*
	9.4 Initiate implementation of the anticorruption strategy.			December 1998*
10. Modernize public sector management	10.1 Establish an interministerial committee, coordinated by the National Agency for State Administration to recommend measures for modernizing public sector management covering (i) decentralizing public administration, (ii) private sector provision of public services, and (iii) a staffing and salary review.	February 1998		
	10.2 National Agency for State Administration to prepare a set of recommendations agreeable to the ADB in terms of transparency and accountability on, among other things, modernizing the public sector.		May 1998*	
	10.3 MOF to undertake a comprehensive study on public provision of services, their pricing and cost-benefits.		June 1998	
	10.4 MOF to identify, based on the study, areas to rationalize the provisions of these services and identify area for privatization.		June 1998	
11. Capacity building of MOF	11.1 MOF's Education and Training Agency to develop and implement a capacity-building program to enhance the quality and skill levels of MOF officials dealing with risk assessment, new financial products, financial services, and other relevant subjects.		March 1998	

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
12. Capacity building of the Financial and Development Supervisory Board (BPKP)	12.1 BPKP to develop and implement a capacity-building program aimed at raising the quality of public-sector auditors, including the inspectorate generals in the various ministries, focusing on performance and evaluation audits.			September 1998
II. INCREASE DISCLOSURE AND TRANSPARENCY OF FINANCIAL INFORMATION				
A. BANKING				
13. Introduce greater transparency and improve governance	13.1 Issue guidelines/regulations for commercial banks on information to be included in the annual financial statements. This should include publication of detailed information on asset quality, lending to affiliated parties, BI ratings, overseas borrowings, rescheduled loans, exposure to real estate, and provisioning, specifying a schedule for implementation.		June 1998	
	13.2 Introduce a separate subcategory for rescheduled loans within the current performing category.		April 1998	
	13.3 BI to amend regulations relating to loan loss provisioning to provide (i) 1% provisioning for total loan portfolio, (ii) 5% provisioning for special mention loans, (iii) 20% provisioning for substandard loans, (iv) 50% provisioning for doubtful loans, and (v) 100% provisioning for uncollectible loans, without deducting collateral value from provisioning requirement; changes to be made effective from 1 April 1998.		April 1998*	
	13.4 Introduce full tax deductibility for loan loss provisions.			September 1998*
	13.5 Review adequacy of existing accounting and auditing standards for all corporate financial statements (banks and nonbanks).		April 1998	

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
B. CAPITAL MARKETS				
14. Increase disclosure and transparency of financial information by listed companies	<p>14.1 BAPEPAM to require the stock exchanges to issue listed company guidelines that deal with corporate governance, responsibilities of managers, and financial disclosure requirements.</p> <p>14.2 BAPEPAM to be organized, including establishment of an enforcement bureau and an accounting standards bureau to implement regulatory powers granted under Capital Market Act No. 8.</p> <p>14.3 BAPEPAM to undertake a special review of accounting and auditing standards and practices to determine areas in which improvements are needed to bring current standards and practices in line with generally accepted international accounting and auditing standards and practices.</p>	December 1997		<p>September 1998</p> <p>September 1998</p>
C. PUBLIC FINANCIAL MANAGEMENT				
15. Improve transparency of the budget	15.1 Implement a new budgeting system that incorporates all subsidies in the budget.	February 1998		
16. Improve the accountability of funds onlent to local governments and government agencies	<p>16.1 MOF to initiate a time-bound program to improve accountability by consolidating all onlent funds, computerizing all financial and legal records on onlending operations, and specifying that MOF will take measures to identify delinquent borrowers of onlent funds.</p> <p>16.2 MOF to undertake a study to identify delinquent borrowers of onlent funds, and prepare a time-bound program of measures to recover funds.</p> <p>16.3 Install and operate a computerized MIS for onlending operations.</p>	February 1998		<p>July 1998</p> <p>December 1998</p>
17. Improve the financial accountability of state-owned enterprises (SOEs)	17.1 Government to issue regulations transferring the supervision of all SOEs to MOF.	February 1998		

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
18. Increase level of disclosure in operational and financial statements	17.2 BPKP to commence a performance audit on selected SOEs and activities including special state agencies such as BULOG, the audit will focus on operational and financial activities, and will recommend time-bound measures to improve accountability and transparency.		June 1998*	
	17.3 MOF to issue (i) regulations requiring increased disclosure in audited financial statements of SOEs, and (ii) a decree on the publication of SOE audits		June 1998	
	18.1 Enact legislation/regulations making (i) auditors liable for negligence in performing audits, and (ii) directors liable for false information contained in the annual report and any other public information, and liable for all board decisions.			September 1998*
	18.2 Review and amend legislation/regulations to make financial disclosure, regulation, and enforcement consistent with international best practices.			August 1998
19. Increase disclosure of the financial performance of unlisted private sector companies	19.1 Issue regulations requiring the filing and public accessibility of audited financial reports of corporations with total assets of Rp 50 billion and above; issue a decree on full disclosure of financial performance of the above corporations.	February 1998		
20. Consolidate all nontax revenues under the May 1997 Non-Tax Revenue Law	20.1 MOF to initiate a program to improve accounting for nontax revenues. The program will include sources of such revenue and provide recommendations to rationalize and consolidate such revenue from different sources.	February 1998		
III. STRENGTHEN THE LEGAL AND REGULATORY FRAMEWORK OF THE FINANCIAL SECTOR				
A. BANKING				
21. Strengthen supervision capacity of BI	21.1 Amend the Central Bank Law to increase the independence of the BI in monetary management and supervision.			December 1998*
	21.2 Introduce a requirement that on-site inspections of commercial banks be undertaken at least every 18 months.	February 1998		

POLICY OBJECTIVES	ACTIVITY	PRIOR TO BOARD CIRCULATION	PRIOR TO SECOND TRANCHE	PRIOR TO THIRD TRANCHE
	21.3 Issue guidelines that mandate specific remedial actions in response to specific capital adequacy levels.		April 1998*	
	21.4 Issue regulations to require that rescheduling of all loans in excess of Rp 100 billion be reported to BI		April 1998	
	21.5 Include assessment of risk management systems and compliance with prudential standards in external audits and BI supervision.			December 1998
	21.6 Strengthen enforcement of mandatory penalties (e.g., downgrading of CAMEL rating, fines) for breach of prudential regulations.	January 1998	Ongoing	Ongoing
22. Establish regulatory framework for nonbank financial institutions	22.1 Examine the relationship between banks and nonbanks with a view to coordinate the regulatory frameworks and thereby remove distortions.		June 1998	
23. Establish framework for debt recovery	23.1 Review the legal and institutional frameworks for debt recovery, including establishment of an arbitration system, and prepare an action plan.			September 1998*
	23.2 Implement reforms to the debt recovery system.			December 1998
B. PUBLIC FINANCIAL MANAGEMENT				
24. Improve the framework for bankruptcy, secured transactions, and avoidance of money laundering	24.1 Enact laws to provide a legal and judicial system of arbitration to address private commercial disputes.			December 1998
	24.2 Revise laws and regulations on bankruptcy and secured transactions.			December 1998
	24.3 Initiate a training program for personnel involved in bankruptcy procedures and secured transactions.			December 1998
	24.4 Enact legislation to prevent money laundering.			December 1998

Note: *means tranche release condition.

BAPEPAM means Badan Pengawas Keuangan dan Pembangunan (Finance and Development Supervisory Board).

APPENDIX 2

CHALLENGES OF CORPORATE DEBT, RESTRUCTURING, AND GOVERNANCE¹

A. Introduction

The financial sector, specifically the banks were assumed by both the government and the IFIs to be the epicenter of the crisis. However, it is now generally accepted that the Indonesian crisis was not just a “banking crisis”, but fundamentally a twin crisis of the banking and corporate sectors that were closely intertwined and required simultaneous attention. Bank restructuring ultimately was going to be dependent on the capacity of corporates to service their debts. And given that corporate earnings were a key source of public revenues (through the tax system), corporate recovery had a central role to play in recovery from the crisis and in the transition to growth. Therefore corporate debt/restructuring was a critical area whose full importance and relevance to the crisis were neither sufficiently recognized nor reflected in the design of the IFI adjustment programs.

As a consequence, the IMF-led program did not address the corporate debt/restructuring issue until after the second LOI (after January 1998). In particular, the critical second LOI included a variety of extensive structural reform conditionalities that did not directly deal with crisis-related issues but more generally aimed at restoring confidence. At the same time, it lacked a focus on corporate debt/restructuring, a core issue in terms of both the crisis and the longer-term strengthening and reform of the economy. The World Bank, the primary lead in this general area, began to play an active role only around mid-1998. Therefore given limited appreciation of the importance of the corporate dimension of the crisis, focus on this issue started late; analysis/diagnosis undertaken was lacking; measures were generally of limited effectiveness; and progress has been limited to date, constraining the Indonesian economy's recovery and transition to growth.²

Therefore a critical lesson of the Indonesian crisis is that banking sector and corporate sector restructuring are in, effect, two sides of the same coin; both need to be addressed *simultaneously*. Bank restructuring is necessary, but unless parallel restructuring takes place in the corporate sector, it is not sufficient to create a viable financial sector.³ The implications of the omission of sufficient focus on corporates in the adjustment strategy and programs is that banks, with liquidity now restored, are not lending to corporates, where precrisis problems are still seen as widespread. Instead, banks are focusing on other types of customers such as SMEs, retail, and consumer banking.

¹ Based on extensive interviews with senior Government of Indonesia officials (present, past); ADB staff; other IFI staff; and Indonesian private sector (corporate, financial).

² One perspective is that the slow start and limited focus was in part due to a philosophy that saw corporate problems as best left to the private sector. A similar view holds that there was an implicit assumption by both IFIs and the government that the way to go was to “fix the banks, and they will fix the corporates”, through their financial oversight of corporate performance through bank lending. A further factor raised in defence of the relative neglect of this issue is a concern about the political feasibility of addressing the problems of large corporates—though the political feasibility issue applied equally to the (private) banks.

³ The Korean experience illustrates the benefits of corporate restructuring for the financial sector.

B. The Corporate Debt Problem

1. The Problem

To put the issue in perspective, according to the Jakarta Initiative Task Force (JITF), total corporate debt as of March 2000 stood at Rp 1,207 trillion, or approximately \$116 billion, of which SOEs had debts of Rp 89.2 trillion (around 7% of the total); SMEs around Rp 194.5 trillion (around 16%); and large corporates around Rp 923.1 trillion (around 77%). The foreign debt share of total debt was just under \$60 billion, of which large corporates held over 90%. It was estimated that approximately 54% of all loans were “distressed” (or around \$63 billion), including around 56% of all domestic loans.

As touched on in the paper and in Appendix 4, the problems of the banking sector were then to a large extent anchored in the problems of the corporates. It is the corporate loans that became the NPLs in the banking system, reaching around 50% in 1998 (or substantially higher by some estimates).⁴ This was in part a consequence of vastly overstated values of loan collateral, as reflected in the IBRA asset sales where the real (recovery) value of loan collateral for the bad loans was around 28% of their reported value.⁵

2. Key Issues

Fundamentally, the books of the corporates were distorted: they did not reflect accurately the real value of their assets, nor did they reflect the true risks in their liabilities. Lack of transparency and accuracy in corporate financial reporting hid the real status of corporate balance sheets. This distorted both corporate investment decisions, and decisions about corporates, specifically lending decisions of banks. That is, banks contributed to and compounded distortions in the economy by failing to perform the basic function of screening in corporate lending, thereby distorting the balance sheets of the banks as well. This was a function in part of corporate financial disclosure issues, as well as other factors, in particular, “directed lending” (both politically inspired, and to related companies within the same corporate group). To put it differently, lack of “good governance” in the corporate sector became a source of fundamental distortions in the financial sector—compounded by lack of “good governance” of the banks.

In this context, a suggestive different perspective on the crisis is to see it as a loss of confidence not primarily in the banks as generally thought, but in the corporates.⁶ According to this view, the market realized in 1997 the accumulation of problems originating in the corporate sector, and the drastic plunge in the rupiah reflects an assessment and reaction by the market to these deeper concerns. There is a realization that the liability side of the corporate balance sheet is vulnerable (dollar-denominated debt rises in rupiah); while the asset side is overstated, which in turn has critical implications for the state of the banks—undermining confidence in both the “real” and financial sectors—a situation not fully understood at the time by the government or the IFIs.

⁴ Halim (2000), for example, estimates NPLs in private banks reached 72% in 1998, from 3.3% in 1997.

⁵ See Appendix 4 for discussion of IBRA.

⁶ This is the perspective of one of the key participants on the Government of Indonesia side who was involved in virtually all aspects of the issue at the most senior level.

C. Addressing the Problems of the Corporates

1. Measures for Facilitating Corporate Debt Restructuring

In March 1998 a consensus was beginning to emerge among debtors and the IFIs that some limited government involvement was necessary, primarily in the form of an exchange rate guarantee, given the core issue of the dollar debts of corporates in the face of a plunging rupiah. In June a voluntary framework for corporate debt restructuring was agreed in Frankfurt. In July/August the Indonesia Debt Restructuring Agency (INDRA) was established by presidential decree, modeled on Mexico's FICORCA scheme, where creditors and debtors were provided a guarantee against further depreciation of the exchange rate from its value at the time the debt was restructured.

There was very limited interest shown in participation in the INDRA scheme by the corporate sector. This was in part because the insurance provided against further exchange rate depreciation was not sufficiently attractive, especially in light of the damage caused by exchange rate depreciation that had already occurred. Given the structure of corporate (and bank) ownership, there was also an incentive for asset stripping, to protect assets that maintained their value by transferring them to entities better sheltered from creditors (related party sales).

Furthermore, while restructuring would take time, shortage of working capital was a critical immediate constraint, especially given a devastated banking sector that was in no position to provide funds to corporates. This was especially important in that, as noted earlier, recovery of the banks (and of the economy) was going to be ultimately dependent on the capacity of corporates to service their debts and generate (taxable) revenues.

To complement INDRA, the "Jakarta Initiative" was launched in September 1998 with technical assistance from ADB, WB, and IMF, aimed at establishing principles to guide and streamline out-of-court corporate debt restructuring. It became operational near the end of 1998, more than one year after the onset of the crisis, and at the end of a year when the Indonesian economy imploded. This initiative was more successful, providing a framework for voluntary restructuring through INDRA. It complemented amendments to the Bankruptcy Law aimed at providing incentives for debtors and creditors to negotiate; and included provisions for creditors to provide interim financing to distressed companies. By 2000 it was handling 170 companies with debt over US\$21 billion, with 15 companies having reached some form of debt restructuring arrangement with creditors, amounting to about US\$1.5 billion in foreign debt, through debt-equity swaps, reduction in interest rates, or extended repayment periods.

However, basic corporate problems remain; and the involvement of the government in addressing such problems continues to be limited to the role of facilitator.

2. A Note on Corporate Governance

Failures of corporate governance are seen as a key factor contributing to the crisis. Lack of transparency and accuracy in corporate financial disclosure, asset stripping (transfer from listed to unlisted companies within the same corporate group), and misallocation of corporate resources for investment in nonrelated businesses (real estate) are all examples of corporate governance problems.

In the current business environment, Indonesia appears to be well advanced in terms of the forms of corporate governance such as legislation, codes, and different institutions. For example, the Corporate Law, drafted in 1995, serves as the basis for corporate governance. Patterned after the Dutch model, in the Indonesian two-board structure, the board of commissioners provides strategic guidance and oversight, while the management board is in charge of running the corporation. Both boards are expected to report at the annual shareholders

meeting. The 1995 Capital Market Law regulates listed companies, establishing rules on financial disclosure and auditing, and preventing insider trading.

The actual practice of governance and the enforcement of the rules, however, is generally recognized as weak. One key reason is the concentration of ownership or control of public companies. For example, at the onset of the crisis, controlling shareholders held an average of 48.2% of all shares, with less than 30% considered freely floated or available for sale to the public. Families continue to dominate listed companies; and of all firms publicly traded, 71.5% were classified as family owned, with only 5.1% defined as widely held. The concentration of ownership provides constraints on market forces as “drivers” of good governance. For example, ineffective commissioners and directors are partly the result of such a structure where they tend to be proxies for controlling shareholders, with little knowledge of duties required of them. At the same time, minority shareholders/investors have limited ability to influence key decisions.

More fundamentally, many corporates do not yet see the benefits of good corporate governance.⁷ For example, it is not seen as a key factor in accessing financing or preferential credit, but instead compliance is often seen as a potential “cost” that may weaken corporate performance, placing a complying firm in a competitive disadvantage with respect to those that ignore such issues. The market rewards profitability, and this is not yet seen as a function of good corporate governance.

Therefore to improve corporate governance, firms need to see the benefits of good corporate governance; or clear and enforced penalties for bad governance. This requires either tangible evidence that shows payoffs from good governance, such as access to financing;¹ and/or legal reforms that enforce clear sanctions for bad governance. Only in this way will the necessary changes be brought about in attitudes and behavior. However, such legal reforms are not yet in place; there are as yet no real incentives for most corporates to comply with good governance. And without change in incentives, behavior is unlikely to change. In this environment, introducing regulations, legislation, and codes of conduct is likely to have at best limited impact—until perceptions of the benefits and costs of compliance change.²

BAPEPAM, which acts as the public securities commission supervising and controlling licensing, is tasked with coordinating efforts at improving good governance. In this, it has a potentially important role to play in terms of inducing and enforcing good practice. BAPEPAM has operational autonomy within a well-defined legal framework, and is implementing a “blueprint” for improving corporate governance and performance. A key requirement is to strengthen the institution’s capacity for implementation, surveillance, and enforcement. In this, a fundamental issue relates to the basic approach of BAPEPAM (as well as that of the Jakarta Stock Exchange, a private, self-regulatory body). Although it has the power to impose sanctions ranging from written admissions to fines to revocation of business licenses, a “disclosure-based approach” supported by a system of “social punishment through sanctions” is the preferred method of enforcement, and is seen to have limited impact. A more aggressive enforcement orientation is likely to be required, which in turn requires the support of an effective legal and judicial system.

⁷ Based on interviews with senior executives.

⁸ In this context there are indications that the investment community is ready to respond favorably, see for example the Global Investor Opinion Survey 2002 of McKinsey and Company (2002).

⁹ The banking sector is one area where significant improvements to corporate governance are being made, with a sectoral code in preparation. The reason is in part because in a regulated sector, it is somewhat easier to enforce such codes.

3. Legal and Judicial System

As noted, a critical factor in ensuring good corporate governance is a sound legal and judicial system that enforces sanctions against bad corporate governance. This has been, and continues to be perceived as a fundamental weakness in the Indonesian context. An example of this relates to enforcing bad debt resolutions through the court system. In addressing the problems of bad debt, collateral has proven to be limited value. In particular, the legal system has proven to be of limited help in allowing the recovery of bad debt by taking ownership of collateral. In this context, as part of the IFI-supported adjustment program, amendments to the Bankruptcy Law were enacted in 1998, and with it creation of a commercial court. However a series of court decisions (against creditors, in the case of Asia Pulp and Paper and the Jakarta Stock Exchange Complex; and Manulife—a different type of high-profile case) have undermined the credibility of the system in the eyes of the international investment community. As touched on in the paper and in Appendix 4, a key continuing constraint on full recovery of the Indonesian economy is the refusal of the banking sector, flush with liquidity, even today (as of the end of 2004) to lend to what they see as deeply troubled corporates.

APPENDIX 3 DILEMMAS IN PROGRAM DESIGN: THE SECONDARY MORTGAGE FACILITY

A. The Concept

Prior to the crisis there was a very small domestic bond market in Indonesia. This, coupled with a very limited equity market, resulted in a bank-led and bank-dominated financial system. In this context, the original concept of the Secondary Mortgage Facility (SMF), in preparation as part of the Indonesian Country Programme prior to the crisis, was to create an entity with a credible balance sheet that would issue high-quality domestic bonds to help stimulate the domestic bond market. The basic intent was to help diversify financial institutions and instruments.

Given a very small domestic bond market, part of the need was to establish a benchmark interest rate. The SMF was to be established to raise finance by issuing bonds on the domestic market with the proceeds to be applied to refinance the mortgage portfolios of banks and other mortgage providers, in general, helping to bring about a better matching of assets and liabilities. With the SMF in preparation prior to the crisis, a number of banks expressed interest in taking an equity position. The concept was for ADB and BI to each take 10% equity, and the rest to be taken by a consortium of 10 or more banks.

However, once the crisis broke, there was debate within the ADB team about including the SMF in the Program. The concern was less the relevance of the concept to the Indonesian economy and financial system (as discussed above). The key issue was whether inclusion of the SMF was relevant at this particular time: did it really “fit” the Indonesian context of deep crisis. At that stage, there was limited indication of government interest—policy attention preoccupied by a rapidly worsening crisis—and the primary push was from the ADB side. Eventually, the SMF was rolled into the Program and made a core condition. ADB was to provide \$50 million, \$3 million in direct equity in the SMF, and the remaining \$47 million to the government institution to on-lend to SMF. ADB provided an advisory technical assistance to help develop the concept and draft a decree to provide a legal framework for SMF. The MOF issued the decree on 27 February 1998.

B. The Problem

During Program implementation, under the pressure of the crisis, the SMF turned out not to be feasible within the changing Indonesian context. In particular, there were two key factors that made the SMF concept unworkable. Under the new 1999 BI law (passed to meet an IMF condition) to create an independent central bank responsible for monetary policy but no longer bank supervision, the BI could not hold the required equity position in the SMF. In addition, given the depth of the crisis and its impact on banks, the SMF was no longer a viable proposition: the banks were in no position to invest in SMF in the midst of a contracting economy and systemic distress in the banking sector. As a result, the \$47 million investment loan for SMF was cancelled on 18 October 2001 at the request of the government, and the \$3 million equity investment in SMF lapsed after more than 12 months had passed.

C. The Issues

Two issues arise from the SMF case. First, should the SMF have been included in the Program in the first place, especially as a core condition, given its very limited relevance to a rapidly deepening and widening crisis? Although the concept may have been relevant to diversifying the financial sector over the longer term, it was not in any way linked to core crisis concerns. As noted, there was debate within the ADB team along these lines.

The second issue relates to whether the SMF should have been left in the Program in the extended interval between completion of Program design, and approval—when the situation in Indonesia was clearly deteriorating rapidly. The Program design was finalized in January 1998. It was then delayed because of the “IBRA problem”, until approval in June. The issue is whether there was—or could have been—sufficient knowledge of the changed conditions in Indonesia during this period, between January and June 1998, to realize that the SMF was no longer appropriate or feasible, and therefore should be removed from the Program before approval in June. At the very least, should it have been left as a core condition. There is a view that indeed this was the case, that there was sufficient information and time available to remove what was a debatable component of the crisis program loan in the first place (Asian Development Bank 2001). If this had been done, a key constraint on program implementation and third tranche release—an irritant to ADB–government relations—could have been removed.

An alternative view holds that there was no such clear understanding of the issues in the middle of the pressures, urgency, and complexity of the deep crisis, which continued to worsen in June 1998, and whose full scope and impact even then were not fully appreciated by the IFIs or the government. Furthermore, keeping in mind a change in government in May 1998 following violent riots—the replacement of President Soeharto by President Habibie—it would not have been prudent to reopen negotiations with the new government in an environment of political crisis and uncertainty (exemplified by the severe May riots, and a new president whose position was none too secure), compounded by an economic crisis that was fundamentally a crisis of confidence. Instead, it was imperative that ADB show immediate support to the Habibie government in the middle of a deep economic crisis and escalating political uncertainty, in order to help build confidence both inside and outside Indonesia.

On the government side, there are clear indications that there was limited focus on details of the policy matrix in general at senior levels at a time of deepening economic crisis, social instability, and political uncertainty and change. Therefore it is likely that the SMF could have been removed from the policy matrix without any repercussions or additional delays. However, it is not clear whether the ADB team under the intense pressure of rapidly escalating events was realistically in a position to appreciate this.¹⁰

¹⁰ From discussions with present and former senior Government of Indonesia officials.

APPENDIX 4

INSTITUTIONAL CHANGE AND POLITICS IN BANK RESTRUCTURING: THE CASE OF IBRA

A. Overview

The defining characteristic of the crisis in Indonesia was systemic distress: the simultaneous insolvency of large numbers of banks and enterprises. Financial and corporate restructuring under such conditions poses complex technical problems. However, the issues are not simply technical and economic. In the short run, the process of restructuring generates political conflicts over the recognition of losses and their allocation among stakeholders—shareholders, management, workers, taxpayers. In the long run, restructuring addresses even more fundamental issues, such as corporate governance and accountability, transparency of business–government relations, effectiveness of the legal and judicial system, and even distribution of society's assets. Beyond the political dimension, addressing these issues also requires that a minimum level of institutional capacity be in place for implementing required actions, e.g., technical capacity to identify illiquid and insolvent banks; institutional framework for disposing nonperforming loans. This range of issues then broadly defines the scope and challenges of restructuring the financial sector and related corporate restructuring. Furthermore, in the case of Indonesia, decisions related to restructuring the banking sector involved ultimately four successive presidents, beginning with President Soeharto in a highly centralized system, transforming into an increasing pluralistic political system.

Activities central to the financial restructuring process, and of direct relevance to the Indonesia program loan, are summarized in Appendix Table 1, and include the following, with the focus here on issues (i)–(iii):

- (i) identification of troubled (illiquid and insolvent) banks
- (ii) bank recapitalization
- (iii) disposition of nonperforming loans
- (iv) restructuring of corporate debt and corporate restructuring
- (v) reform of corporate governance

APPENDIX TABLE 1
THE POLITICAL ECONOMY OF FINANCIAL AND CORPORATE RESTRUCTURING*

ACTIVITIES	POLITICAL ECONOMY DIMENSION
Identification of troubled banks, categorization, and limiting support to insolvent banks	Readiness and capability of government in both focusing and limiting liquidity support and guarantees to failing banks; allocation of losses among government, depositors, owners, etc.
Bank recapitalization	Readiness and capability of government and provision of adequate resources; imposing conditions on banks; limiting costs to government of recapitalization by encouraging private sector recapitalization
Disposition of NPLs	Readiness and capability of government in putting in place needed institutional framework; identifying and financing “carve out” of NPLs; pricing assets; timely rehabilitation or disposition of assets; maximizing value in asset disposition
Restructuring of corporate debt	Facilitating timely restructuring; imposing conditions on corporates; limiting cost to government/public
Reform of corporate governance	Overcoming resistance for greater transparency, corporate accountability, external monitoring
Strengthening legal and regulatory framework	Ensuring that the necessary legal and regulatory framework is in place, including systems of laws and rules for corporate governance; transparent financial reporting; supervisory regulations on bank operations, including institutional framework; bankruptcy and foreclosure laws

Source: Adapted from Table 4.1 in Haggard (2000).

B. Strategy in Indonesia

1. Identification of Troubled Banks

The critical first step in restructuring the banking sector involves the categorization of banks into (i) healthy banks with liquidity problems in need of assistance; (ii) unhealthy banks advised to merge; and (iii) those banks that need to be liquidated. The necessary prerequisite for categorization of the banks before restructuring and recapitalization can take place is accurate information on their status. This information was initially not available for most banks because of financial information distortions, and institutional (i.e., BI) weaknesses. Lack of reliable banking information, in turn, contributed to the significant difficulties experienced with the initial (November 1997) bank closings that relied on available but misleading BI information.

Therefore a key initial focus of the IFI programs supporting bank restructuring was on improving the information base for categorizing banks. This involved providing support for international accounting firms to review the books of the banks. These audits were carried out primarily in the second half of 1998. In this context, the mid-1998 audits undertaken on six private banks taken over by IBRA (established in January 1998 as a special purpose institution with responsibility for restructuring NPLs and selling off assets and banks, see Section III) revealed both the complexity and magnitude of the problems. On average, NPLs at these banks were 55% of total

loans, reaching 90% in the case of one bank, with many of the loans to affiliate companies: in effect the banks were “deeply insolvent.”

Once the initial information is available, the primary focus of banking reform is on strengthening potentially viable banks. The information requirements involved may be illustrated in Indonesia as follows. In the case of private banks, potentially viable banks were ones that have a CAR after full provisioning for all impaired loans (based on findings of the international firms), of greater than 23% but less than 4% of assets. In principle, restoring these banks involved shareholders injecting 20% of the new capital needed to achieve CAR above 4%, with the rest injected by the government by taking a commensurate equity position; updating related parties on all NPLs and reducing their level to within the new regulatory requirements; preparing an acceptable business plan showing how it can achieve medium-term viability, and compliance with all BI regulations; finalizing agreements with former bank owners for repayment obligations; and passing the “fit and proper test” of its owners and managers.

Bank restructuring goes beyond issues about capital. Good services, extensive branch networks, excellent human resources and management are important attributes of a good bank, and information on these aspects of bank operations are an important part of the information base for restructuring decisions. For example, in the case of Category B banks that do not contribute the 20% additional capital and have been taken over by the government, their extensive branch networks were an important reason for not liquidating them.

2. Bank Recapitalization and the Role of BLBI

(i) Private Banks

The recapitalization program of private banks was launched by IBRA in September 1998. The banks were categorized into three groups based on the audit by international accounting firms through the IFI-supported adjustment program. The CAR of Category A banks were above the cut-off 4%, and were allowed to resume operation. Those between 4% and –25%, Category B, were candidates for the recapitalization program provided that their owners/shareholders could inject the required 20% of new capital to attain CAR of 4%. Banks with a CAR of less than –25% were put in Category C and their owners/shareholders were given a certain amount of time to inject sufficient equity to push them into Category A or B, qualifying these banks for the recapitalization program. Category B and C banks whose owners/shareholders could not inject the required capital were to be taken over by IBRA or closed.

The results of the audits were announced after delays in March 1999. It was found that under Category A, 73 banks had CARs of at least 4% and therefore were not included in the capitalization program. In Category B, nine banks were to be recapitalized, provided their owners met the requirements; seven were to be taken over by IBRA; and 38 were to be closed. The remaining 17 Category C banks with CARs below –25% were judged insolvent with no prospect of regaining financial viability.

(ii) State Banks

The large assets of the seven state banks underline their importance in the financial system, and their huge NPLs required financial resolution. Even though all the state banks and a number of the regional banks fell into Category C, given their scale and perceived importance in the system, all were recapitalized after restructuring and mergers. In December 1997 the government announced the plan to merge four state banks (Bapindo, Bank Bumi Daya, Bank Dagang Negara, and Bank Exim)—with extensive NPLs—into what became Bank Mandiri. Bank

Rakyat Indonesia was left to serve as a “small-enterprise bank.” The merger plan was to result in the downsizing of their operations, leading to the sale of redundant facilities and branch closures, with the plan to eventually privatize the new bank. In the case of the 27 regional banks, 12 needed capital injections.

(iii) Financing Recapitalization

A total of Rp 648 trillion of bonds were issued by the government for bank recapitalization. Of this amount around Rp 430 trillion was in the form of recap bonds. An additional Rp 218 trillion was issued to BI as settlement for cost to BI of the BLBI liquidity support for banks at the height of the crisis to stem the bank rush.¹¹ In addition to the large stock of debt, the interest cost for the budget of this program is very high (interest rates on the bonds vary from 10-16.5%); and some interest payments (on the so called “hedge bonds”) are denominated in foreign currency.

The recap bonds provide a major source of revenue for many banks. Without this source of revenue they would have difficulties paying interest on their deposits. Similarly, if there were to be any question about the government’s ability to redeem the bonds on maturity, their market value would fall significantly, impairing the solvency of banks. Therefore the role and resolution of recapitalization bonds is both sensitive and a continuing challenge to the government.

(iv) Political Economy Dimension

As noted, the restructuring and recapitalization program—a politically highly sensitive undertaking at the best of times—was implemented under four different presidents, and through fundamental changes in the political system. Therefore the government’s (and the Program’s) performance and outcomes should be appreciated within this very turbulent political context. The process was initiated under President Soeharto in a highly centralized presidential system including the closing of the initial 16 banks (November 1997), the decision on the blanket guarantee and the establishment of IBRA (January 1998), and the transfer of the first group of banks to IBRA. After the resignation of President Soeharto, the restructuring and recapitalization continued under President Habibie, followed later by Presidents Wahid and Megawati. The political system evolved to become increasingly pluralistic, with a greater role played by Parliament and the political parties represented there—with direct impact on the restructuring and recapitalization process.

A key political economy issue involves the cost of recapitalization, which in principle, should be borne in the case of private banks by existing owners and supported by proper prudential oversight. However, the blanket guarantee provided by the government in response to the run on banks following the failure of the closing of the 16 private banks in November 1997 meant that the cost of recapitalization was the government’s responsibility. These costs include continuing interest payments on recap bonds, which represent a cost to the government

¹¹ BLBI is the liquidity support from BI—in its role as the lender of last resort—to troubled banks to keep the banking system functioning in the face of massive bank runs during the crisis. BI provided a total of Rp 164.5 trillion, of which 144.5 trillion went to 48 suspended banks and the rest to the state Bank EXIM. For the banks taken over by IBRA, the BLBI support was converted to equity by the government, so it no longer appears as debt in the banks’ balance sheets. This resulted in the transfer of ownership of the banks to the government, which recovers its cash as banks are sold by IBRA. However, the Supreme Audit Board (BPK) discovered through the audit of the recipient banks by international firms, several months after the provision of the support, misappropriation of much of the BLBI funds. If IBRA sales cannot finance the loss, this will be a burden on the taxpayers. The government and BI are trying to reach agreement on burden sharing.

and to the Indonesian public; a (very significant) portion of the BLBI liquidity injection never repaid by bank owners; and partly related losses incurred in the disposition of the NPLs (the difference between their book value and market price on disposition). The government handed over responsibility for restructuring NPLs and selling off assets and banks to a special purpose institution, IBRA. However, the basic issues of the size of the “bank clean up costs”, and how it will be allocated between the government, and therefore the Indonesian public, or shareholders of private banks is as yet not fully resolved (discussed further in the next section).

3. Disposition of Nonperforming Loans and IBRA

(i) Indonesian Bank Restructuring Agency

There is no clear and agreed upon modality of government involvement in bank restructuring ranging from market-based approaches, to the establishment by governments of special purpose institutions. For example, different institutional approaches were used in Indonesia, Korea, and Thailand. In the case of Indonesia, the functions of bank restructuring and asset management were consolidated in a new agency, IBRA, as a centralized public asset management company. This was established in part to cushion BI from the fiscal and political costs of bank restructuring and asset management; and in part to cushion these functions from perceived problems at BI—whose regulatory and supervisory shortcomings were seen as key contributing factors to the crisis.

The IBRA was established under the bank restructuring package of 26 January 1998 under a presidential decree, and subsequently mandated through an amendment to the Banking Act to oversee rehabilitation and restructuring of the banking sector. IBRA's mandate was to take over, recapitalize, merge, or close troubled banks, with the recapitalized banks eventually to be sold. IBRA was also to be the management agency for the assets acquired in restructuring, and therefore given the tasks of monitoring and selling corporate assets pledged or transferred from former bank owners as collateral for emergency BI liquidity credits (BLBI). IBRA was also to recover bad loans belonging to banks that have been taken over or closed, and to implement the loan guarantee system.

(ii) The Challenge

The centralization of bank restructuring and asset management functions in one agency defined a rather extensive scope of work, requiring a wide range of capabilities from a new institution. Furthermore, perhaps less by design than by circumstance, IBRA was placed at the center of what amounts to a struggle for the “future division of wealth in Indonesia”, subject therefore to tremendous political pressure. Furthermore, IBRA was plagued from the outset not only by the very broad and confusing mandate, but also lack of sufficient legal and regulatory powers, weak Indonesian legal system, and allegations of corruption.

The fundamental question was whether IBRA had the political support as well as the administrative and operational capacity to carry out its mandate. The signs were not encouraging at the outset. It seemed that IBRA had little room for independent maneuver, and was subjected early to turnover of high-level personnel, with four chairmen in less than 2 years. The political complexity of the task was underlined by events such as the Bank Bali scandal under President Habibie, and President Wahid intervening directly in several important restructuring cases in ways that undermined IBRA's independence. In addition, IBRA has not received consistent support from the courts.

Operationally, the biggest test for IBRA was whether it could recover on the accumulating portfolio of rather diverse set of assets it held, which included (i) assets surrendered or pledged by former shareholders of frozen banks against repayment of liquidity credits (BLBI liabilities); (ii) NPLs from both private and state-owned

banks; (iii) and shares in troubled banks. All in all, assets under the control of IBRA during the period (1999–2002) were valued roughly at well over Rp 500 trillion or over \$55 billion, over 55% of Indonesia’s GDP. However, the assets of the liquidated banks were considerably below their reported values. Due diligence conducted by international auditing companies revealed that their assets were worth only around 20% of the value reported by previous auditing companies. Therefore IBRA was saddled with bankrupt companies whose real values were well below their outstanding debts.

Within this context, there were fundamental differences of perspective over how IBRA should exercise its power, particularly given the diversity of assets it controlled. There has existed an inherent contradiction between the mandated IBRA objectives of getting the best price for foreclosed assets, with a target of 70% recovery on total assets as opposed to getting the best settlement with debtors, and acting swiftly to dispose of assets both to reduce the short-term liquidity constraints on government, and the wider uncertainty surrounding the NPL process.¹² Those emphasizing the first path, getting the best price, argued that IBRA should get into the asset rehabilitation business, including through offering debtors “haircuts” (and leaving them in control of their businesses) and swapping debt for equity (which implies haircuts). At the limit, this strategy could involve more ambitious operational and even industrial restructuring efforts. But this strategy would have required IBRA to have both political independence and administrative capacity to undertake such an ambitious strategy. The alternative strategy, to dispose of assets quickly, was favored by those who saw problems in any form of government intervention in the rehabilitation process. They saw IBRA and corporate owners and managers aligned against a group of willing buyers, both domestic and especially foreign.

More fundamentally, implicit in conflict over objectives and strategy is a difference in perspective on the political economy of bank restructuring and recapitalization: who should bear the burden of the crisis and recovery. If it was explicitly recognized that the 70% recovery level was not realistic, it meant a substantially higher cost of the crisis and recovery strategy would be borne by the government, and therefore the taxpayers. For example, if IBRA managed to recover 20 to 40 cents on the dollar, which many felt was a realistic estimate, then bailing out the banks is estimated at a cost to the Indonesian public around \$40 billion, equal to almost 150% of the government budget.

(iii) Performance by the Completion of the Program (Late 2002)

In the case of asset sales, the disposal of NPLs from private and state-owned banks, sales were delayed until mid-1999, then proceeded slowly. The situation as of late 2002 was as follows: total loans transferred stood at book value Rp 294.735 billion, of which 86.5% were corporate loans, constituting 1% of the debtors; the total assets sold stood at book value Rp 133,800 billion; with cash proceeds of around Rp 33,407 billion, or a recovery rate of around 27%; leaving IBRA assets originally valued at Rp 160,935 billion, of which restructuring SOEs involved book value Rp 64,000 billion; and leaving assets originally valued at Rp 96,000 billion still to be disposed of by IBRA—assumed to be the worst of the assets since the better ones sold early (Purnomo 2002). In the end, at its closing in April 2004, IBRA was able to achieve a recovery rate of 28% on the assets it held.

There were very limited sales of banks for an extended period. However, bank sales have accelerated since mid-2002 mainly to foreign investors, with recent sales including: 51% of Bank Central Asia to a strategic partner, a consortium led by a US asset fund (April 2002); 51% of Bank Niaga to a strategic investor from Malaysia (September 2002); 51% of Bank Danamon to a combined Singapore-German strategic investor group; and 20% IPO of Bank Mandiri on the Jakarta Stock Exchange. A further IPO is planned for October/November of 2003 of Bank Rakyat Indonesia. However, there are continuing concerns about the original conglomerates reasserting their control over banks through proxies.¹³

¹² Other conflicting pressures related to such as foreign participation; letting former owners buy back assets.

As of late 2002 the restructuring of the banking sector remained highly concentrated. The largest bank, Bank Mandiri, accounted for more than 25% of total assets, with the top 10 banks of a total of 145 accounting for around 75% of total assets. Ownership was heavily concentrated in the state through the recap bonds, prior to the recent privatization sales by IBRA, which is diversifying ownership. For example, in late 2002 only two of the top 10 banks were fully privately owned, with only five foreign banks ranked among the top 20. Deposits were also highly concentrated as of late 2002, with more than 66% of the total number of accounts under Rp 5 million, but these represented only 8% of the total value of accounts. At the same time very large deposits of Rp 1 billion or more represent less than one tenth of 1% of the total number of deposits, but more than 36% of their total value (Kenward 2002).

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