Sovereignty and Intervention in Financial Crises

by

Nader Alexander Mousavizadeh

A.B. Harvard College, 1992
M.Phil. Oxford University, 1994

Submitted to the Alfred P. Sloan School of Management in Partial Fulfillment of the Requirements for the Degree of

Master of Business Administration

at the

Massachusetts Institute of Technology

June 2004

© Nader A. Mousavizadeh. All rights reserved

The author hereby grants to MIT permission to reproduce and to distribute publicly paper and electronic copies of this thesis document in whole or in part.

Signature of Author: ____________________________

MIT Sloan School of Management
May 6, 2004

Certified by: ____________________________

Richard Locke
Alvin J. Siteman Professor of Entrepreneurship and Political Science
Thesis Advisor

Accepted by: ____________________________

Stephen Sacca
Director, Sloan Fellows Program
Sovereignty and Intervention in Financial Crises

by

Nader Alexander Mousavizadeh

Submitted to the MIT Sloan School of Management on 6 May 2004
In Partial Fulfillment of the Requirements for the Degree of

Master of Business Administration

Abstract

Sovereignty today is conditional, compromised and contractual in ways that require a reassessment of the doctrine of sovereignty in an era of globalization and global capital markets. Taking as a case study Indonesia during its financial crisis in 1997-1998, this thesis explores the sovereign ability of a state such as Indonesia to act effectively and independently in its own economic interest in a crisis. The argument of this thesis that sovereignty today is conditional, compromised and contractual to an unprecedented degree rests on two pillars: first, that a universal awareness of human rights increasingly has imposed a contract on sovereign leaders demanding, as a condition for the right to sovereign non-interference, that they respect the most fundamental human rights of their citizens. Second, as the case of Indonesia will demonstrate, that in the global economy where contagion is a real and dangerous phenomenon, countries must accept IMF conditionality or find themselves cut off not only from assistance from the International Financial Institutions but, more importantly, from private investors whose loss of confidence in an economy can trigger a serious financial crises with severe long-term consequences for the society as a whole.

Thesis Supervisor: Richard Locke
Alvin J. Siteman Professor of Entrepreneurship and Political Science
Chapter I

Introduction

The changing nature of state sovereignty is a defining – if often overstated – aspect of globalization. Sovereignty – for the purposes of this study – is defined not as international legal authority. It is defined as autonomous domestic control over the political and economic policies of the state, as well as over the flow of goods, capital, ideas and people that cross its borders. Sovereignty thus defined has undergone a dramatic evolution in recent years, even as conceptual and policy frameworks have failed to follow suit. This gap has implications not only for the understanding of state sovereignty, but also for the ways in which states and international institutions seek to contend with the consequences of greater integration and interdependence as a consequence of globalization.

The twin challenges to sovereignty that defined the last decade of the 20th century – humanitarian intervention on one hand, and financial contagion and conditionality on the other – emerged during a decade of dramatic increases in the global scope, depth and velocity of flows of ideas, capital, goods and people. News, technology, jobs and consumer goods all reached an increasing audience, transcending borders, cultures, language and ethnicity. While this may not have been a new phenomenon historically speaking – the Greeks, the Romans, the Persians, the British were all globalizers of a kind – the global penetration of contemporary globalization knows no historical parallel.
State sovereignty, in its traditional form – the form in which it remains almost universally considered today – is a doctrine that establishes the right of states and their governments to exercise authority free from external influence – in the political, economic, financial and security spheres. Since the mid-17th century, sovereignty – in this definition – has been more an aspiration than a reality, a rhetorical barrier against external dictates to be invoked far more than it has served as a true defense of autonomous action. Still, this doctrine did help to ground relations between states in the modern era, and to provide a framework for non-interference in the domestic affairs of other states – a framework which also plays an important role in the Charter of the United Nations. What has changed – and deepened dramatically – over the past two decades has been the gap between aspiration and action, between rhetoric and reality, when it comes to the ability of states to deploy the doctrine of sovereignty in defense of sovereign independence.

What I wish to argue – from a study of the theory of sovereignty, and the application of that theory to the case of Indonesia in 1997-1998 – is that we no longer should think of sovereignty as “eroding”, “changing,” “diminishing,” or “declining”, as so much of contemporary literature on this subject does. Nor should we continue to think of sovereignty in its ideal type form – a simple doctrine of independence and autonomous authority. Rather, we should begin to understand sovereignty in the deeply interdependent 21st century as increasingly conditional, compromised and contractual. What is meant by this is that sovereignty today is no longer an inalienable right – as it has been considered certainly in the half-century since the post World War II era of
decolonization, particularly by the newly independent states.

Sovereignty today is *conditional* in the sense that the bearer of sovereignty increasingly must fulfill certain conditions to maintain it; it is *compromised* in the sense that states increasingly volunteer limits to their sovereign freedom of action in order to obtain financial, security, or political benefits; it is *contractual* in the sense that there is increasingly an explicit bargain between the state and, one on the one hand, its citizens, and, on the other, the broader community of states of which it is a part.

Sovereignty should, today more than ever, be thought of as a responsibility as well as a right, an obligation as much as privilege. From below, the citizenry can increasingly make claims on the bearer of sovereignty to make him refrain from causing harm to the people; from above, the community of states can make claims on the bearer of sovereignty to make him refrain from causing harm to that community.

Sovereignty remains a constitutive attribute of the contemporary state system. But as it becomes increasingly conditional, compromised, contingent and contested in a globalized world, it will become less a bulwark against external interference than a measure of a state’s political and economic integration into the 21st century global community. With time, sovereignty may become a sign of weakness, not a source of independence.

The conventional conception of sovereignty is a historical relic which needs to be
reassessed if it is to serve the international state system in world defined by globalization and the increasing belief in the universality of human rights. While some have gone so far as to claim the “end of sovereignty” and the “irrelevance of the state,” the argument presented here will draw on evidence that sovereignty is simultaneously more contested and more resilient that often described.

During the financial crises that struck Asia, and then Russia, and then Latin America in the late 1990s and early 2000s, a number of emerging markets were confronted with dual threats to their sovereignty: first, by the “disease”, in the form of speculative attacks on their currencies facilitated by liberalized capital markets; second, by the “cure”, in the form of IMF intervention intended to stabilize the economies by imposing a wide range of conditions attached to its bail-out packages. While international capital markets arguably were more open before the First World War than they are today, modern technology and the speed with which information flows at the beginning of the 21st century have increased dramatically the relative power of such markets.

How sovereign states respond to the movements of 21st century international capital markets – and how their sovereignty can be thought of as increasingly conditional, compromised, and contractual – will be the focus of this thesis. Through the prism of the case of Indonesia during the Asian financial crisis of 1997-1998, and the application of theories of sovereignty to that case, I wish to demonstrate that sovereignty has undergone this evolution, and draw lessons from it.
Chapter II

Sovereignty: Conditional, Compromised, Contractual

Since the mid-17th century, states have asserted a preeminent, constitutive right to autonomy in their domestic affairs. Globalization, it will be argued, has significantly widened the gap between the rhetorical claim to sovereign independence and the reality of sovereignty as increasingly conditional, compromised and contractual as a consequence of interdependence.

To develop this argument, and subsequently to apply it to the case of Indonesia during the 1997-1998 crisis, this chapter will first consider the historical and intellectual origins of sovereignty, as doctrine and practice, before examining its evolution. What are the origins of the doctrine of sovereignty? What forms of sovereignty can we observe today? What is the main impact of globalization on sovereignty? And finally, and most importantly, what are the ways in which sovereignty can be said to be conditional, compromised or contractual today?

This chapter will then examine contemporary challenges to orthodox conceptions of sovereignty in the political and economic spheres by exploring, first, the debate that took place in the late 1990s about humanitarian intervention in defense of human rights; and second, the impact of technology, communication, and the free flow of goods and capital on the economic autonomy of sovereign states.
Finally, this chapter will conclude with a brief analysis of the history of sovereign lending and the role of the international financial institutions and the conditions they attach to bail-out programs and stand-by arrangements. It is intended that this will serve as a useful foundation for the examination of the challenges to Indonesia’s sovereignty during its financial crisis in 1997-1998.

The Origins of Sovereignty

The sovereign state model is generally considered to have its origins in the Peace of Westphalia in 1648, which ended the Thirty Years War, and postulated as a cardinal principle of the European post-war system the freedom of religion within states which were considered to be in legitimate control of a certain defined territory. This was, at the doctrinal level, the impact of the novel religious principle *cujus regio ejus religio* -- which placed the choice between Protestantism and Catholicism in the hands of local rulers -- on the concept of sovereignty.\(^1\) It was the moment when, as another writer put it, an “international equivalent of religious liberty was agreed upon”\(^2\) among what were then considered the sovereign states of Europe. Since then, the territorial sovereignty of nation-states has been a “central, indeed a constitutive, feature of the modern world.”\(^3\)

John Ruggie notes that the distinctive feature of this system of rule is that it differentiated

---

its subject collectivity into territorially defined, fixed, and mutually exclusive enclaves of legitimate dominion.⁴

F.H. Hinsley, an early theorist of this question, defined sovereignty as the "idea that there is a final and absolute political authority in the community."⁵ Given the degree to which sovereignty as a concept, and ordering principle of the international system, has evolved, it is important to note the historical context in which it developed. While Stephen Krasner argues that the theoretical underpinnings of sovereignty in the works of Bodin and Hobbes were rooted in their intention to "establish the legitimacy of some one single source of authority within the polity,"⁶ Hinsley notes that for Bodin (whose work on sovereignty preceded the Peace of Westphalia by more than half a century), the sanctity of sovereignty stemmed from the fact that he "feared anarchy more than he disliked tyranny," and therefore insisted that "misrule could constitute no right to restrain, depose or assassinate the sovereign."⁷

It was not that Bodin did not distinguish between sovereignty and absolutism, in the form of Hobbes’s Leviathan. Still, it would be left to Althusius in the early 17th century to develop an explicitly contractual theory of sovereignty – one that would posit that the "authority of the government results from an agreement, tacit or express, between the ruler and the ruled."⁸ For him, the source of all governmental power is ultimately

⁴ Ruggie, p. 151  
⁷ Hinsley, p. 122  
found in the people. Later on, Locke and Rousseau would both emphasize the contractual nature of sovereignty, and of the people as the only possible bearer of sovereignty. And finally, the idea that states ought to be autonomous, free from intervention by external actors was only developed as an explicit principle in the last part of the eighteenth century by the Swiss international jurist Emmerich de Vattel. While all these theorists (to varying degrees) considered sovereignty to have some contractual element, it was Althusius who saw sovereignty in terms of the kind of conditionality and contingency that is found today – particularly in the field of economic assistance.

Today, as Thomas Heller and Abraham Sofaer point out, “the concept of sovereignty [should not be seen as] a set of established rules, to which states must bend their conduct in order to preserve their capacities. It is instead an ever-changing description of the essential authorities of states, intended to serve rather than control them in a world that states dominate.” Finally, Hinsley, the early and important theorist of sovereignty, argued far before the current period of globalization that “it is wrong to conclude that because the state has experienced a decline in its international freedom of action, sovereignty is no longer compatible with the state’s international position. To argue in this way is to associate the attribute of sovereignty with the possession by the state of freedom to act as it chooses instead of with the absence over and above the state of superior authority.”

---

9 For a good general discussion of this question, see Stephen Krasner, “Rethinking the Sovereign State Model”, Review of International Studies (2000), 27, pp. 17-42
11 Hinsley, p. 226.
What has changed, therefore, is the nature of the limits on what Hinsley called “the freedom of action” of states to make independent sovereign decisions in their own interests – not the fact that limits exist. The limits are, following Althusius, contractual and conditional in nature, but the source of the limits are today very different. From below, it is the citizens of the state who make (or are able to make) contractual demands on the sovereign to an unprecedented degree; from above, it is the community of states that makes contractual demands on the sovereign; and finally, as we will see from the case of Indonesia, from above and below, it is the international capital markets that make contractual demands on the sovereign.

The Evolution of Sovereignty

The oldest usages of the term sovereignty – what Krasner calls Westphalian sovereignty -- refer to the autonomy of domestic authority structures, and the absence of authoritative external influences. Closely related to this doctrine has been the principle of non-intervention as a defining characteristic of sovereignty. This is one that weaker states, in particular, have emphasized – since the mid-17th century, but also in the post-colonial period. Non-intervention also represents one pillar of the somewhat schizophrenic UN Charter, the other being universality which in itself implies, if not authorizes, interventions in violation of the principle of sovereignty.

A key fault line in contemporary studies of sovereignty lies between those who, on the one hand, consider the challenges to sovereignty posed by globalization to be

12 Krasner, “Problematic Sovereignty”, p. 2.
unprecedented, and, on the other, those who believe sovereignty never existed in any “pure form” and has always been subject to violations and limitations. Stephen Krasner, among others, has emphasized the “historical myopia” of those who write about sovereignty today as dramatically eroding as a consequence of globalization.

“The now almost commonplace view that sovereignty is being eroded is historically myopic. Breaches of the sovereign state model have been an enduring characteristic of the international environment. The principle of autonomy has been violated in the name of other norms including human rights, minority rights, democracy, communism, fiscal responsibility, and international security. … There has never been some golden age for sovereignty.”\(^{13}\)

Krasner outlines four meanings of sovereignty -- domestic sovereignty, Vatellian sovereignty, international legal sovereignty, and interdependence sovereignty. Of primary interest to this analysis of sovereignty is the last meaning termed “interdependence sovereignty.” Krasner defines it as follows:

“... [Interdependence] sovereignty is being eroded by globalization resulting from technological changes that have dramatically reduced the costs of communication and transportation. States cannot regulate transborder movements of goods, capital, people, ideas, or disease vectors. Governments can no longer engage in activities that have traditionally been understood to be part of their regulatory portfolio: they cannot conduct effective monetary policy because of international capital flows ... The issue here is not one of authority but rather of control. The right of states to manage their borders is not challenged, but globalization, it is asserted, has eroded their ability to actually do so.”\(^{14}\)(emphasis added)

What Krasner elsewhere posits, however, (and this somewhat contradicts his occasionally strident criticism of the “new sovereigntists” who see sovereignty as changing as a result of globalization) is that sovereignty has indeed been – and is today – “compromised” in a variety of ways. In this view, compromises of Westphalia have

\(^{13}\) Krasner, “Rethinking the Sovereign State Model”, p. 17
\(^{14}\) Krasner, “Rethinking the Sovereign State Model”, p. 20.
occurred in four ways – through conventions, contracting, coercion, and imposition. In the “contractual” compromise of sovereignty – the form that will be examined most closely in this study -- rulers agree to violate the sovereignty of their own state contingent on other signatories honoring their part of the bargain. Rulers are not forced into such arrangements – at least not in the conventional sense, though we will examine below the degree to which the option of opting out of the international system for most states is real. They enter them – at least theoretically – voluntarily because compromising the principles of the sovereign state model is more attractive than honoring them, Krasner concludes.  

A contract, in this sense, can violate the sovereign state model if it subjects domestic institutions and personnel to external influence, or creates institutional arrangements that transcend national boundaries. Historically, sovereign lending, especially to weaker states, has frequently involved contractual arrangements that compromise the autonomy of the borrower. Borrowers have not simply agreed to repay their obligations, an arrangement that would have no impact on autonomy. Rather they have agreed to dedicate specific revenues, or to accept oversight of domestic policies, or to permit revenues to be collected by foreign entities, or to change their domestic institutions.

As the preceding discussion of Krasner’ typologies of sovereignty suggest, this is a subject rich with opportunities for theoretical debate, and contending definitions of how  

\[^{15}\] Ibid., p. 23.  
\[^{16}\] Ibid., p. 26  
\[^{17}\] Ibid., p. 26
exactly one can define – and describe – sovereignty today. It should be clear, however, that for the purposes of this thesis -- which treats as its case study the state of Indonesian sovereignty during its financial crisis in 1997-1998 -- we will concentrate on what in Krasnerian terms would be described as “compromises” “by invitation” of Indonesia’s “interdependence sovereignty.” To take just one example, no one at the time was contesting Indonesia’s “international legal sovereignty”: indeed, the very fact that it could and did engage with international financial institutions as a state and an independent government – however compromised that sovereignty might have been in reality – showed that it still was considered sovereign in international legal terms.

Finally, where Krasner uses the term “compromises” to describe the various concessions of sovereignty, Heller and Sofaer usefully point to an alternative terminology, by suggesting that “delegations of sovereignty” have occurred throughout the history of the Westphalian state system. This, in their view, is an act that confirms, rather than contests, the resilience of sovereignty. That a state, a polity, is able to delegate, share, pool or concede sovereignty shows precisely that they remain the primary possessor of sovereignty. How can you cede what you do not own?

In this view, the fact that states are increasingly surrendering some of their policy options through international agreements and sharing their authority and functions with international institutions and non-governmental forces that participate in making, applying and enforcing the rules of transnational life -- this “this thickening net of
treaties, regional associations, and international agencies” -- is more an expression of the value of sovereignty than a threat to its continuing importance.\textsuperscript{18}

Krasner would appear to endorse this view when he notes that “while Westphalian sovereignty can be compromised through invitation as well as intervention, invitation has received less notice in the literature because observers have confounded international legal and Westphalian sovereignty. Intervention, he points out, violates both. Invitation violates only Westphalian sovereignty. Invitation occurs when a ruler voluntarily compromises the domestic autonomy of his or her own polity: “free choices are never inconsistent with international legal sovereignty.”\textsuperscript{19}

Sovereignty – as doctrine as well as attribute of independent states – has not only evolved throughout time, but it is also of varying importance to states, depending on their state of development as well as their political and cultural history. But what Heller and Sofaer refer to as “essential authorities” of states – particularly weak states reliant on international financial assistance – are increasingly subject to intrusive conditions.

Robert Cooper reminds us that “loss of control is not restricted to countries like Indonesia, since both the spread of terrorism and that of weapons of mass destruction point to a world in which Western governments are losing control.”\textsuperscript{20} Nevertheless, in both political and economic terms, sensitivity to violations of sovereignty remains far

\textsuperscript{18} Heller and Sofaer, pp. 25-31
greater in many developing countries. As Richard Stubbs points out, in such countries “the empirical sovereignty exercised by the institutional states bares no relationship to what is assumed by the assigning of juridical sovereignty to the territorial state.”21 As Sohail Hashmi emphasizes, state sovereignty is often considered a “badge of international legitimacy for states and regimes enjoying at best dubious internal legitimacy.”22 He continues:

“New and relatively weak states that have recently emerged from colonization are likely to assert and demand full sovereign prerogatives in the international arena before they contemplate transferring some of their sovereignty to international institutions ... International institutions thus find themselves assuaging fears of erosion of sovereignty harbored by threatened states before any real progress is possible in resolving vital issues.”23

We see, in short, how sovereignty as a principle and a right is considered most precious for those who can claim it least. In addition, sovereignty is still sacred is in the world of great power states like the Russia and China (and to a slightly lesser degree the United States), which remain fundamentally attached to the state system in the classical, Westphalian sense remains intact. The United Nations Charter is the legal, constitutional embodiment of this system, and the authority to which states in the modern system appeal refer when disputing what they consider to be infringements on their sovereignty.24

---

23 Ibid., p. 13.
24 Cooper, pp. 22-23.
Countries such as India, Pakistan and China – as well as Indonesia – which are preoccupied with economic development, internal security and cohesion deeply resent external interference which they see as a “challenge to state sovereignty and a threat to internal order.” And yet these states cannot escape what Cooper calls the “hegemony of the post-modern.” They find themselves enmeshed in a web of institutions and alliances governing trade, transport, communications and many other facets of a global economy. While these states try to resist the infringements of the post-modern, sometimes, as we will see with the case of Indonesia, in order to get access to financial markets – they may find themselves having to accept interference in their economic affairs from the IMF.

For advanced industrial countries with the highest per capita incomes – in particular those in Europe which also share a history of catastrophic warfare in the past hundred years – an excessive attachment to sovereignty is not only considered redolent of a nationalist politics, but also an impediment to the kind of trans-border cooperation and integrations necessary to create a larger, more efficient, and more prosperous market. There, the “pooling of sovereignty” is considered a virtue, and the more traditional insistence on maintaining sovereignty (in its purest form, at least rhetorically) no longer considered in the national interest. And if, as the members of the EU believe, post-modern cooperation and acceptance of external intrusion and interference improves your economic and political security then – and this is central – this “violation” of conventionally construed sovereignty will in fact have strengthened a state’s ability to exercise its sovereignty. Sovereignty, in this view, is most effective, and most useful,

---

25 Ibid., p. 23
when it goes beyond “the control of territory and armies to the capacity to join international bodies and to make international agreements.”

This suggests that while sovereignty remains a powerful reality in the contemporary state system, states are increasingly agreeing to compromises that, by invitation, condition their interdependence sovereignty on their ability to fulfill certain requirements of the international state system – both political and economic.

Sovereignty and Humanitarian Intervention

In the political sphere, the last decade of the 20th century was marked by a series of ethnic conflicts in post-imperial and post-colonial settings, where ethnic grievances were harnessed to ideologies of domination on a genocidal scale. These developments – and the simultaneous emergence of a world-wide awareness of human rights -- began to challenge what was considered to be the most sacred right of sovereign states: freedom from outside interference in the treatment of their own citizens. While this challenge took many forms in a variety of arenas, it is instructive to examine it in the context of the United Nations – an organization of sovereign states explicitly founded on the principle of non-interference in the internal affairs of states. Krasner alludes to the scope of this dilemma when he notes that “after the Second World War nonintervention was routinely endorsed in major treaties, such as the Charter of the United Nations, although ethnic

---

26 Ibid., p.44.
27 This section draws on the author’s personal role as adviser to U.N. Secretary-General Kofi Annan during this period, including in the formulation of the Secretary-General’s policy on this question. The speeches quoted in this section can be found on www.un.org.
conflicts in the 1990s prompted Kofi Annan, the Secretary-General of the United Nations, to argue at the fall 1999 General Assembly that sovereignty might have to be conditioned on respect for human rights.²⁸

For the United Nations, this challenge was not theoretical in nature. From the war in Bosnia to the genocide in Rwanda to the conflict in Kosovo, the United Nations has been a principal actor in situations where the doctrine of state sovereignty – at least in the eyes of its own members – seemed to conflict with the larger cause of the United Nations, namely to defend and advance human rights wherever they might be imperiled. For no one was this dilemma as acute, or as problematic, as for the Secretary-General of the United Nations, Kofi Annan. As a senior official of the UN Department of Peacekeeping Operations, he had witnessed – and played a role in – United Nations policies of neutrality and non-interference that to many observers appeared in conflict with the principles of the organization, not to mention of little help to the victims of those conflicts.

As Secretary-General, therefore, Annan sought carve out a distinctive position which departed from the orthodox view of the member states of the organization while maintaining a basic respect for the principle of sovereignty to which so many member states – in particular those of the South – attached such great importance. In a series of speeches over the year 1999, he set out what became know as the Annan Doctrine emphasizing that state sovereignty could no longer be considered a shield behind which states could commit gross violations of human rights. He began elucidating this doctrine

²⁸ Krasner, “Problematic Sovereignty”, p. 12.
at the UN Human Rights Commission meeting in April 1999 by expressing his regret that the international community had failed to prevent the conflict in Kosovo. He continued:

“What gives me hope -- and should give every future “ethnic cleanser” and every state-backed architect of mass murder pause -- is that a universal sense of outrage has been provoked. Emerging slowly, but I believe surely, is an international norm against the violent repression of minorities that will and must take precedence over concerns of state sovereignty. It is a principle that protects minorities -- and majorities -- from gross violations. And let me therefore be very clear: even though we are an organization of Member States, the rights and ideals the United Nations exists to protect are those of peoples... No government has the right to hide behind national sovereignty in order to violate the human rights or fundamental freedoms of its peoples. Whether a person belongs to the minority or the majority, that person’s human rights and fundamental freedoms are sacred. This developing international norm will pose fundamental challenges to the United Nations. Of this, there can be no doubt. But nor can there be any doubt that if we fail this challenge, if we allow the United Nations to become the refuge of the “ethnic cleanser” or mass murderer, we will betray the very ideals that inspired the founding of the United Nations.”

One month later, he further elaborated on the dilemma facing the international community, and, in particular, the Security Council:

“This is the core challenge of the Security Council and the United Nations as a whole in the next century: to unite behind the principle that massive and systematic violations of human rights conducted against an entire people cannot be allowed to stand. For in a world where globalization has limited the ability of states to control their economies, regulate their financial policies, and isolate themselves from environmental damage and human migration, the last right of states cannot and must not be the right to enslave, persecute or torture their own citizens.” (emphasis added)

Finally, in addressing the last General Assembly of the 21st century, the Secretary-General put the choice to the membership of the United Nations, in language explicitly addressing the dilemmas of sovereignty by alluding to Isaiah Berlin’s essay on liberty through the use of the idea of “two concepts of sovereignty.”
“State sovereignty, in its most basic sense, is being redefined by the forces of globalization and international cooperation. The state is now widely understood to be the servant of its people, and not vice versa. At the same time, individual sovereignty -- and by this I mean the human rights and fundamental freedoms of each and every individual as enshrined in our Charter -- has been enhanced by a renewed consciousness of the right of every individual to control his or her own destiny. If states bent on criminal behaviour know that frontiers are not an absolute defence; if they know that the Security Council will take action to halt crimes against humanity, then they will not embark on such a course of action in expectation of sovereign impunity.”

On the very day that the Secretary-General delivered his address, an Australian-led force landed in East Timor to help complete the province’s separation from Indonesia. He said, that day, “Let me say that the Council’s prompt and effective action in authorizing a multi-national force for East Timor reflects precisely the unity of purpose that I have called for today. Already, however, far too many lives have been lost and far too much destruction has taken place for us to rest on our laurels. The hard work of bringing lasting peace and stability to East Timor still awaits us.”

Throughout that year, Annan was developing his doctrine on sovereignty and intervention with very clear reference to events in Kosovo, and with the intention of seeing that doctrine have some impact on the steps the international community would take to prevent another Bosnia in the Balkans. Faced with an escalating Serbian campaign of expulsions, killings and intimidation in Kosovo in late 1998 and early 1999, the Secretary-General was presented with a basic choice. Either he would accept the argument that the Serbian authorities had the right to “maintain order” by whatever means necessary within their sovereign borders or he would assert basic principles of
human rights and international humanitarian law, and reject the idea that sovereignty
trumps human rights. On 30 January, he spoke to the NATO leadership:

“The bloody wars of the last decade have left us with no illusions about the
difficulty of halting internal conflicts -- by reason or by force -- particularly
against the wishes of the government of a sovereign state. But nor have they left
us with any illusions about the need to use force, when all other means have
failed. We may be reaching that limit, once again, in the former Yugoslavia. Let
me begin with Kosovo.”

The Secretary-General’s statement to NATO was widely interpreted as a
recognition that the threat of force was a necessary tool in the diplomacy leading up to a
settlement for Kosovo. On 24 March, NATO decided to launch air strikes against the
FRY without receiving explicit Security Council authorization. This decision crystallized
the Secretary-General’s dilemma regarding Kosovo. The Secretary-General had long
condemned the Serbian campaign and called for effective measures in response. Now,
such measures were being employed, not, however, by a united Security Council, but by
a military alliance acting unilaterally. The Secretary-General’s statement on the eve of
military action, on 24 March, acknowledged this dilemma:

“I speak to you at a grave moment for the international community. Throughout
the last year, I have appealed on many occasions to the Yugoslav authorities and
the Kosovo Albanians to seek peace over war, compromise over conflict. I
deeply regret that, in spite of all the efforts made by the international community,
the Yugoslav authorities have persisted in their rejection of a political settlement,
which would have halted the bloodshed in Kosovo and secured an equitable peace
for the population there. It is indeed tragic that diplomacy has failed, but there
are times when the use of force may be legitimate in the pursuit of peace.”
(emphasis added)

By effectively endorsing the NATO action – which in strictly legal terms had to
be considered illegal under the UN Charter, and therefore by the Secretary-General –
Annan made clear that he believed the age of sovereignty as defined by non-intervention in the internal affairs of states was over. And the case on everyone’s minds on the day the doctrine was set out to the General Assembly was East Timor and its independence from Indonesia.

What this examination of the evolution of the UN’s approach to the question of sovereignty in the 1990s demonstrates is that the conception of sovereignty can, with time, change as practice and policies reflect lessons learned and the willingness to apply those lessons.

**Sovereignty, the Global Economy, and Sovereign Lending**

While the question of sovereignty and intervention in the political/human rights sphere has been more fiercely and more recently contested as a consequence of the (however unfinished) development of a norm for intervention in defense of universal human rights, it has for some time been more widely accepted that the global economy represents, by its very nature, a “violation” of traditional forms of sovereignty. In this case, it is not, to use Krasner’s terminology a question of whether a state possesses international legal sovereignty – whether it is the recognized authority within a certain territory. Rather, *it is a question of control* – to what extent can a government truly be considered to be in control over its own policy matters. Before globalization manifested itself as widely and deeply as today, Richard Cooper emphasized that in a world of large
open capital markets, smaller state would not be able to control their own monetary policy because they could not control the trans-border movements of capital.

Among the more alarmist interpretations of this evolution of sovereignty is Saskia Sassen’s Losing Control? Sovereignty in an Age of Globalization. Her view, which is representative of much of the anti-globalization literature, is that “the formation of a global capital market represents a concentration of power capable of influencing national government economic policy and, by extension, other policies as well. These markets now exercise the accountability functions associated with citizenship: they can vote governments’ economic policies down or in; they can force governments to take certain measures and not others.”

While this view may overstate the power of markets and underestimate the resilience of state sovereignty, we will, as in the case of Indonesia, see that a factor as intangible and de-territorialized as global “market confidence” can play a powerful role in setting the parameters for the economic policies of states dependent on assistance from the international financial institutions and investments from private investors. As Sassen notes, “the growth of the global economy in conjunction with the new telecommunications and computer networks that span the world has profoundly reconfigured institutions fundamental to processes of governance and accountability in the modern state. State sovereignty, nation-based citizenship, the institutional apparatus in charge of regulating the economy, such as central banks and monetary policies – all of

---

these institutions are being destabilized and even transformed as a result of globalization and the new technologies.\textsuperscript{30}

It is, at this point, important to note that in the financial and economic sphere, far from all concessions of sovereignty have been forced on states and their governments. In many cases, states voluntarily (though one must be skeptical about the degree of “free will” genuinely available in a global economy) agree to limits on the sovereign right to set economic policy in return for financial or economic benefits, e.g., in the form of loans or beneficial trade agreements.

Still, without inventing a mythical past of perfect national autonomy, it is clear that, unlike today, “governments used to have a whole array of policies to govern their national economies: policies on taxes, public spending, interest rates, credit controls, exchange rates, capital controls, and income … and that the global financial markets have affected all of these, some of them sharply,” as Sassen has written. As one example she cites the foreign currency market, which, as she notes, “operates largely in electronic space and has achieved volumes – a trillion dollars a day – that leave the central banks incapable of exercising the influence on exchange rates they are expected to wield.”\textsuperscript{31}

What has, in this view, been the effect on sovereignty? Sassen argues that national territory itself has been partially “denationalized” and that there has been a partial shift of

\textsuperscript{30} Ibid., p. xii.
\textsuperscript{31} Ibid., p. 21.
some components of state sovereignty to other institutions, from supranational entities to the global capital market.32

The influence of John Ruggie’s work on territoriality and the state is clear. In his view, the globalized economy is best understood as a “system of trans-nationalized micro-economic links.” He elaborates by noting that

“these links have created a non-territorial “region” in the world economy – a decentered yet integrate space-of-flows, operating in real time, which exists alongside the spaces-of-places that we call national economies. These conventional spaces-of-places continue to engage in external economic relations with one another, which we continue to call trade, foreign investment, and the like, and which are more or less effectively mediated by the state. In the non-territorial global economic region, however, the conventional distinctions between internal and external once again are exceedingly problematic.”33

Whether it can truly be said that there now exists a global economy outside the conventional spaces of international society, setting economic policy has long been a privilege and responsibility of a national government as the elected (or not) representatives of the citizens whose economic well-being they are tasked with advancing. While the debate over how relatively new this phenomenon is will continue, it would benefit from a understanding of how different forces are working in opposite directions: some bolstering state sovereignty, some seemingly undermining it.

Eric Helleiner, in his work, is inclined to the former view, pointing to information-sharing, regulatory cooperation and legal assistance as processes through which states are regulating their own markets in an “internationally harmonized way,”

32 Ibid., p. xii.
33 Ruggie, p. 172.
thereby strengthening sovereignty. At the same time, he does concede that the vast
sums of speculative capital able to enter and exit weak and shallow economies make it
difficult for those governments to set independent interest rates or control the value of
their exchange rate.

Here, too, it is essential to maintain historical perspective, even while we can
claim that changes of a different order are taking place in the meaning of sovereignty.
International capital markets were more open before the First World War than they are
today. Krasner points out that international banking began in Europe in the later Middle
Ages, and that in the early modern era European rulers were highly dependent on
international finance, much more dependent than would be the case for any developed
states in the contemporary era. In addition, Britain, the major source of international
capital in the nineteenth century, was much more dependent on global transactions before
the First World War than was the case for any country at the end of the twentieth century.
By 1914, 10 percent of British income and 6 percent of French income were generated by
foreign investments. Nearly a quarter of British wealth was invested overseas.35

The history of sovereign lending in the 19th century is even more revealing for a
study of economic compromises of sovereignty. Then, weak and financially strapped
states agreed to a wide variety of deeply intrusive conditions in order to gain access to

34 Eric Helleiner, “Sovereignty, Territoriality and the Globalization of Finance”, p. 144, in States and
Sovereignty in the Global Economy, David A. Smith, Dorothy J. Solinger and Steven Topik, eds. (London:
Routledge, 1999)
35 Krasner, Sovereignty: Organized Hypocrisy, p. 221.
capital. From Latin America to parts of Europe to the successor states of the Ottoman Empire, states conceded domestic autonomy through contractual loan agreements.

One example is provided by Greek history. When it was recognized as a state in 1832, Greece received a 60m franc loan from Britain, France and Russia. The terms, however, were onerous, and not only in financial terms. Greece had to sign a pledge that “actual receipts from the Greek treasury shall be devoted, first of all, to the payment of the said interest and sinking fund, and shall not be employed for any other purpose, until those payments on account of the installments of the loan raised under the guarantee of the three Courts, shall have been completely secured for the current year.” And in 1838, the entire finances of Greece were placed under a French administrator. Greece continued to borrow substantially throughout the remainder of the century, and finally, in 1897, after a calamitous war with Turkey over Crete, Greece’s finances collapsed.\(^\text{36}\)

Unable to service its foreign debt or to pay the war indemnity that was demanded by Turkey, Greece was forced to accept an international commission of control, which consisted of one representative appointed by each major power, and had absolute control over the sources of revenue needed to fund the war indemnity and foreign debt. Removing all doubt about who was in command of Greece’s finances, the Commission abrogated for itself the right to choose the revenue sources that it would control. Indeed, it did not seem hyperbolic for one member of the Greek parliament to argue that the establishment of the Control Commission suspended the independence of Greece.\(^\text{37}\)

\(^{36}\) Cited in Krasner, “Rethinking the Sovereign State Model,” p. 27.
\(^{37}\) Ibid., p.28.
Robert Cooper cites a different, yet equally revealing 19th century example of sovereign lending. In 1875, a British committee representing bond-holders supervised the revenues of the Egyptian government, while a French committee supervised expenditures. When the Egyptian government was overthrown, the new one threatened to ignore the program. “Instead of trying to renegotiate, Britain sent General Wolsely, with 31,000 men, to restore order and good government.”

As we will see from the following consideration of the Indonesia case, a state would not have to agree to such explicit violations of sovereignty for effective independence to be called into question. Indeed, while we will be considering a case of sovereignty compromised by invitation, rather than imposition, the lines do get blurred and free agency on the part of a government questioned when such powerful actors as the US Treasury and the IMF demand conditions for their assistance – and make offers (to borrow a phrase) that no country can refuse.

*Sovereignty and the International Financial Institutions*

The late twentieth heirs to General Wolseley are to be found in the corridors of the IMF and World Bank – or so the worst critics of the IFIs would suggest. Still, while the methods may be different, the motivations far purer, the intentions (*pace* Joseph Stiglitz) almost certainly to advance the basic welfare of the peoples of the developing countries, the effect of conditionality is often as profound as a full-scale military invasion. To say this is not to engage in conspiracy theories favored by anti-globalization

38 Cooper, pp. 70-71.
protestors, but to suggest the degree to which the role of the international financial institutions – most particularly through the dramatic deepening of conditionality – has, for some countries, made sovereignty more a convenient fiction than actual reality.

What Robert Cooper has called this “limited form of voluntary empire … provided by the programs of assistance of the World Bank and the IMF”39 was never designed as such. As David Williams points out, the principle of non-intervention in the internal affairs of developing countries was enshrined in the World Bank’s Articles of Agreement.40 Cooper underlines the degree to which the Bank and the Fund were seen as sustainers of embryonic national sovereignty on the part of recently decolonized countries -- not as its enemies in the imposition of conditions so intrusive and so wide-ranging as to convey neo-colonial impressions to the peoples of those nations.

As international assistance developed, however, it became increasingly influenced by three parallel factors, each of which would have a significant impact on the trade-off in sovereignty that each borrower would have to accept. First, in the aftermath of the Cold War, there was less of a political incentive to ignore governance abuses on the part of borrowers, and a very tangible political incentive to insist on “good governance” programs as a way of harnessing the impact of lending to a larger free-market democratic capitalist vision of the world.

39 Cooper, p. 70.
Second, it became increasingly clear that economic growth was quite demonstrably tied to whether a country had in place the kinds of institutions that constitute “good governance,” among them an independent judiciary, regulated extraction of natural resources, law and order etc. Third, the acceptance by the IFIs of the basic arguments of neo-classical economics provided additional good reasons for questioning and restricting the activities of the state. Finally, it became apparent – particularly after the Asia crisis of 1997-1998 – that contagion was more than a medical phenomenon. It could cause profound dislocations and disruptions in even sound economies due, among other factors, to information asymmetries which prevented investors from making discerning judgments.

That is not to say that the borrowers’ and the IFIs did not – and do not -- go to great lengths to maintain a fiction of sovereign decision-making, including in the insistence that it is the states themselves, rather than the IFIs, which are suggesting wide-ranging domestic reforms. Williams observers that since “one of the criteria for being respected as a sovereign state is precisely the ability of a government to fulfill the purposes of state sovereignty … both developing countries and IFIs work hard to maintain the view that that sovereignty of developing countries is not under threat from the activities of aid donors.” There are eminently sensible political reasons for this – an attempt to prevent the nationalist backlash against what is often considered neo-colonial behavior by the invariably European or American officials of the IFIs. That, however, does not make it any less of a fiction.

---

41 Williams, p. 567.
42 Ibid., p. 572.
What has made the fiction ever harder to sustain, however, has been the growth and development of conditionality as part of financial assistance programs. The path to conditionality was, in one interpretation, paved with good intentions of IFIs coming up short against the combination of incompetence, corruption and predatory behavior on the part of the governments with whom they dealt. In that sense, in the eyes of the IFIs, many governments have “have failed to fulfil the purposes of state sovereignty, both in terms of economic development and in terms of achieving desirable political and social arrangements….” Governments, in this view, were no longer seen as simply mistaken about economic policy, or inexperienced, or even the victims of unfortunate circumstances; rather they were themselves a major reason for the lack of economic and political development.” As a consequence, “he IFIs have become central players in the attempt to fulfill the purposes of state sovereignty in many developing countries, and in so doing they have become the organizational embodiment of that set of ideals which has, at least since the French Revolution, always potentially threatened state sovereignty.”

This role follows an already expanding role, historically speaking, in the late 1980s with the structural adjustment programs, which began to attach conditions, such as removal of import quotas, the privatization or restructuring of state institutions, cutting tariffs, reducing interest rate control and devaluation of currencies. Nicholas Onuf notes that these demands were part of a larger trend, since World War II, of “contractual arrangements that violate autonomy [becoming] routine for international financial institutions.” He further points out that

---

43 Ibid., p. 567.
44 Ibid., p. 568.
“Conditionality was not part of the Bretton Woods agreements. During the negotiations that created the International Monetary Fund and the World Bank, the European representatives successfully resisted US efforts to give the new institutions significant supervisory powers. Potential debtor countries, the Europeans, wanted to defend their autonomy, whereas the world’s major creditor, the United States, was perfectly willing to violate the sovereign state model. The United States, however, had the money and ultimately the United States prevailed. In 1950, conditionality was accepted in principle by the executive directors of the IMF because it was the only way to induce US policymakers, who had blocked virtually all activities for several years, to allow operations to resume. Conditionality formally became part of the IMF Articles of Agreement by amendment in 1969.”

What is particularly striking about the development of conditionality in assistance programs from the international financial institutions is that they have reached ever deeper into domestic areas not obviously related to the issue of repayment of loans. There is, as Williams notes, “very little of developing countries’ economic, governmental, administrative, institutional, and social structures and policies which IFIs see as being beyond their purview.” This has happened for two reasons: because “good governance” increasingly is considered part and parcel of sound economic management; and second, because the elusive and intangible standard of “market confidence” increasingly is considered as something that must be met with measures that fall outside fiscal policy.

Krasner notes that “in more recent years lenders have been concerned not simply with repayment but also with economic reform for humanitarian, ideological, or security reasons.” Williams underlines that over “the past two decades concern for sovereignty has increasingly been “trumped” by the international donors’ commitment to the pursuit

---

45 Onuf, p. 29.
46 Williams, p. 570.
47 Krasner, “Rethinking the Sovereign State Model,” p. 30.
of “ideal” or good political and social arrangements and economic development within many of these countries. What, to the IFIs, is considered “good governance”? According to the World Bank, good governance entails improving public sector management, restructuring legal systems, decentralizing administration, improving “accountability”, and encouraging “transparency” and information provision.

One important qualifier – one that manifests itself quite clearly, as we will see, in the Indonesian case – is that conditionality is no panacea, the deepening of demands no guarantee that the program will work. A loan can commit both lender and borrower in ways they did not imagine. In particular, lenders may have a complex series of interests and motivations that will not only affect their choice of conditions, but also influence the degree to which non-compliance with those conditions is penalized. Cooper notes, in this regard:

“Financial assistance is always a double-edged sword. One would think that the supply of desperately needed finance would give the IMF a lot of leverage. In practice, things are not so simple. Withdrawing assistance and provoking economic collapse is not in the donor’s or lender’s interest. Setting conditions for loans may be effective while negotiating them, but getting countries to stick to the conditions the have agreed is not easy once they have the money in their pocket. A large proportion of IMF programs are renegotiated in whole or in part ...Using economic assistance to achieve non-economic goals is even more difficult. Suppose aid is made conditional on improvements in human rights: what policy should a government follow when the country concerned pursues admirable economic policies, but fails to do anything about human rights. Cutting off aid is a poor way of rewarding good economic management, and it is unlikely to do much for human rights either.”

---

48 Williams, p. 557.
49 Cited in Williams, p. 569.
50 Cooper, p. 116.
In addition, as Williams observes and as we will see at critical moments in Indonesia's crisis, "developing country governments have been able to resist implementing its loan conditions, and they have dissembled, bargained, dragged their feet, and generally, where they wished, tried to maintain some semblance of control over the process of political and economic reform." As a consequence, success of these agreements in accomplishing their own stated objectives has been limited in part because weak and poor countries are buffeted by external economic changes in terms of trade and interest rates over which they have no control and only a limited capacity to adjust. Moreover, as Krasner notes, "the actual implementation of reform programs can be politically untenable because the power base of rulers in Third World states has sometimes been built on the rent-generating capacities of programs that interfere with market mechanisms – the very same mechanisms the officials of international financial institutions see as key to economic development."

What this thesis will suggest is that the ability of developing countries to resist will weaken over time, given that turbulence in the world economy is now seen as a threat to all societies, and will lead political leaders in stronger state to contemplate intervention – on their own or through the international financial institutions they control. Williams points out that "the activities of the IFIs in their relations with many developing countries certainly suggest that the substance of state sovereignty does not amount to very much more than a show.... It might be argued that this situation arose through the actions of governments who voluntarily entered into contractual relations with the IFI,

51 Williams, p. 571.
53 Ibid., p. 148.
and that in principle this is not different from any other kind of international agreement where states willingly cede some of their authority in return for expected benefits.”\textsuperscript{54}

This does, however, as Williams writes, show a certain naivety about contractual relations between IFIs and developing countries. Also, it ignores more important impact of the role of the IFIs – in some ways more important than the funds they provide – the fact that the two Bretton Woods institutions stand as gatekeepers for the vast bulk of aid flows to the poorest countries.\textsuperscript{55} Finally, as Krasner notes, IMF conditionality agreements, which may include stipulations requiring changes in domestic structures, carry weight not only because they are attached to the provision of funding but also because the IMF has legitimacy for some actors in borrowing countries derived from its claims to technical expertise.\textsuperscript{56}

All these factors were present as the IFIs sought to deal with the crisis in Indonesia – a crisis that led to one of the most extensive and intrusive conditionality agreements in January 1998. That agreement not only specified macroeconomic targets but also stipulated an end to subsidies and government sponsored cartels for enterprises run by members of the president’s family. The IMF announcement of the agreement stated, among other conditions, that “all the special tax, customs and credit privileges for the national car project will be revoked, effective immediately.” This project was run by the youngest son of President Suharto.\textsuperscript{57} What this condition made clear – and the

\textsuperscript{54} Williams, p. 573.
\textsuperscript{55} Ibid., p. 567.
\textsuperscript{56} Krasner, Sovereignty: Organized Hypocrisy, p. 22.
\textsuperscript{57} Ibid., p. 145.
message it sent to others in similar straits – was that once a country entered into negotiations with the IMF, it could basically consider any aspect of its domestic economic policy open to discussion.\textsuperscript{58} No condition, no compromise of sovereignty related to economic or financial affairs -- defined \textit{very} broadly -- was off limits. Global market confidence demanded nothing less.

\textsuperscript{58} Ibid., p. 147.
Chapter III

Indonesia’s Crisis and Conditional Sovereignty

The Lobengula Moment

Perhaps not since 1888 and the signing of the Rudd Concession treaty between King Lobengula, the last King of Matabeleland and agents of Cecil Rhodes, allowing Rhodes to take effective control of what later became Rhodesia, had the world seen as egregious a peacetime display of the surrender of sovereignty as when President Suharto on live television signed the Letter of Intent on January 15 1998 agreeing to the demands of the IMF with a stern-looking Michel Camdessus standing, arms-crossed, behind him. Indeed, it would only have required the IMF’s managing director to have been a Dutch national to put in question whether the Charter of the Transfer of Sovereignty over Indonesia, signed at the Round Table Conference in the Hague on November 2, 1949, really meant what it said when it proclaimed that the Kingdom of the Netherlands “unconditionally and irrevocably transfers complete sovereignty over Indonesia to the Republic of the United States of Indonesia.” Or so, at least, it appeared to much of Asia and the developing world – an impression no amount of evidence about Suharto’s corruption and venality, no degree of agreement about the necessity of reform and transparency in an age of financial globalization, has been able to alter.

Seeing the President of the largest Muslim nation in the world accept what was perceived in much of the developing world as the dictates of Western bureaucrats acting at the behest of Wall Street interests brought to mind a long and humiliating history of
concessions and colonial exploits. Indeed, even the American Ambassador in Indonesia at the time, Stapleton Roy, was appalled by the notion that Washington would have the gall to tell a leader as proud as Suharto how to run his country’s internal affairs.\textsuperscript{59}

Beneath the crude image of Camdessus and Suharto – one that is deeply regretted to this day by the IMF – lay a far more complex history of sovereignty contested, compromised and conditional.

The reality is that Indonesia found itself at the mercy of a power far greater than the IMF in its ability to override sovereignty, namely global financial markets. And the reality is also that its suffering at the hands of these markets was to a significant degree self-inflicted. Understanding the very real limits to sovereignty for nations with open economies in an age of globalization is the aim of this examination of the Indonesian case. The Asian financial crisis as it played out in Indonesia, and eventually led to the downfall of the Suharto regime, is thus a instructive case study of the ways in which sovereignty in an age of globalization is more comprised, and more conditional than ever before.

This chapter will begin with a brief overview of the financial crisis itself, before addressing some of the most important elements of the peculiarly Indonesian character of the crisis, including the role of corruption, the importance of the Chinese “market-dominant minority”, the legacy of authoritarian rule, and the political and geopolitical context. It will then look in more detail at the intervention made by the IMF and its

interaction with the government, before taking a broad view of the question of conditionality vs. ownership in IMF programs. Finally, the chapter will assess what this experience suggests about the imperative of market confidence, and the transformative impact this has had on national sovereignty in times of financial crisis.

*Chronicle of a Crisis Not Foretold*

The financial crises that struck Asia in the late 1990s provided a number of insights into changing nature of state sovereignty in an age of financial contagion. These include the power of emerging markets to withstand speculative pressures in an era of liberalized global capital markets; the ability of external actors – whether they be the IMF or the US Government or international banks – to effect rapid change in domestic economic policies; and the underlying causes of crisis and contagion rooted in a combination of asset bubbles, weak governance and political uncertainty.

Arguably, Indonesia had begun to concede sovereignty (even in the less than pure form that is the case for most states) over its financial and economic affairs some time before the 1997-1998 crisis. Stubbs suggests that the region-wide recession of 1985-86 forced what he calls the newly independent “institutional states” (referring to the strong role of the central government and its bureaucracy) of Indonesia, Malaysia, Singapore and Thailand to accept advice and aid from external authorities and to open up their economies to the rest of the world. The region was now open to the influence of
multilateral agencies such as the IMF and the World Bank.\textsuperscript{60} This was no less true in the case of Indonesia, which, as Robert Cooper notes, could be described as something “between an empire and a nation-state”, which needed to employ the state ideology of Pancasila, as well as the army, to hold it together.\textsuperscript{61}

The effect of the 1997-1998 crisis was, however, particularly devastating to Indonesia. Its recovery from the Asian crisis has been the slowest, in part because its banking crisis was the worst. A combination of rapid expansion of the banking sector, control of ownership in few hands, inadequate institutional and regulatory controls, poor governance, political instability, and integration into global financial markets created a vulnerable financial sector unable to survive the regional crisis.

All this, it must be said, is clear in hindsight. Before the crisis, few observers believed anything like the actual devastation that took place to be possible. If anything, Indonesia was considered one of the more robust, and more well-managed, economies in East Asia during the early and mid-nineties. As Betsy Massar, Andrew Lee et al point out, Suharto, from the time he seized power in 1968, had steadily liberalized the economy, encouraging foreign direct investment. In 1988, a series of further reforms were passed, with key import monopolies being dismantled, and limitations on licenses for private and foreign banks lifted. (These latter reforms were later considered one source of the banking crisis that engulfed the country). As a consequence, the number of

\textsuperscript{60} Stubbs, p. 235.
\textsuperscript{61} Cooper, p. 19.
private banks, many owned by ethnic-Chinese, more than doubled to 135, and 18 new foreign banks were licensed.\textsuperscript{62}

One outcome of these reforms that later came to haunt Indonesia was a rapid and dramatic rise in foreign debt, particularly short-term debt. It is estimated that between 1988 and 1992 alone, total foreign debt rose sharply to almost $80 billion, 30 percent of which was composed of private commercial loans. As long as the Government maintained a fixed exchange rate – and this is was a crucial condition – Indonesian companies could exploit the interest-differential of foreign currency loans, and foreign banks were eager to provide the funds given the extraordinary growth rates enjoyed by Indonesia. Between 1968 and 1996, the Indonesian economy grew at an annual rate of 7.5 percent. On the eve of the crisis, Indonesia was completing its third decade of high growth with low inflation and balanced budgets; its currency did not appear to be overvalued; it had a smaller current account deficit, and less short-term debt, that either Thailand or South Korea; and the Suharto government had an excellent record of economic governance, particularly during times of crisis.\textsuperscript{63}

Indeed, for the first four months of the crisis (after July 1997) the two leading credit agencies – Moody’s and S&P – downgraded the credit ratings of Thailand and South Korea but left Indonesia’s rating unchanged. Moreover, shortly after the beginning of the crisis, the Suharto government took a number of precautionary measures: it first loosened, then abandoned its exchange rate policy, without squandering its reserves to

\textsuperscript{62} Betsy Massar, Andrew Lee, Michael Enright, James Newton, “The Asian Financial Crisis: Indonesia and the Currency Board Proposal”. (Hong Kong: The Centre for Asian Business Cases, 2000), pp. 3-4

\textsuperscript{63} Michael Ross, “Indonesia’s Puzzling Crisis,” (Los Angeles: UCLA, 2001), p. 3.
defend the rupiah; in mid-September it announced a package of measures to boost investor confidence; and in early October, it announced its intention to seek an IMF stand-by agreement. In taking these steps, it behaved like a model emerging market -- by not squandering its resources to defend a dropping currency, by not ignoring the importance of seeking investor confidence, by not waiting too long before turning to the IMF for help.

What happened, then? A capital account crisis, first and foremost, precipitated by a dramatic loss in confidence. In 1996, capital was flowing into emerging Asia at the rate of about $100 billion a year; by the second half of 1997 it was flowing out at about the same rate. Contagion from the devaluation of the Thai Baht on July 7, 1997, brought a region-wide loss of confidence which caused a massive withdrawal of capital, leading to the collapse in the value of the rupiah, which, in turn, made it impossible for Indonesian companies and banks to service let alone, pay short-term debts.

When the baht crisis began, the Indonesian rupiah was valued at 2445 to the dollar; by October 31, when the IMF package was signed, it had dropped to 3650, a loss of almost 50 percent. Between November 1 and the end of January 1998 the rupiah thus lost three-quarters of its remaining value. Even more devastatingly, economic output would shrink by more than 14 percent in 1998, and millions of Indonesians were plunged back into poverty, as median daily wages fell by 30 percent in rural areas and 40 percent

---

64 Ibid., pp. 5-6.
in urban areas.\textsuperscript{66} One cruel irony was that the government’s exceptional level of financial openness – something urged on the country by the IFIs, and the markets generally – in fact allowed worried investors to move their money out of Indonesia quickly and easily, which they did in ruinous quantities.\textsuperscript{67}

Consensus among scholars\textsuperscript{68} is that at least six elements contributed to the loss of confidence in Indonesia: the contagion effect from the Thai crisis, leading foreign portfolio managers to raise their risk profiles for the entire region; corruption; Indonesia’s current account deficit; weaknesses in the financial sector caused by liberalization; the size of the debt burden; and the decision on November 1 to close 16 small banks, several of them controlled by Suharto’s relatives and cronies.

In an atmosphere of regional contagion, financial panic, and a government unable and unwilling to take the steps necessary to restore confidence -- if indeed that was possible, a question that has no clear answer -- the collapse of Indonesia’s economy, something that months before had seemed unthinkable, became inevitable.

\textit{“Corruption, Collusion and Nepotism”}

Having drawn the broad outlines of the onset of the crisis in Indonesia, it is useful to identify the combination of factors that were unique to the crisis in Indonesia, and made this case so difficult to understand, and its long-term consequences so dire.

\textsuperscript{66} Blustein, p. 87.
\textsuperscript{67} Ross, p. 3.
\textsuperscript{68} Summarized by Ross, pp. 9-11.
A principal source of the loss of confidence in the Indonesian government—once contagion had taken effect—was the rampant corruption and cronyism that defined Indonesian society. Not that corruption was anything new, or that Indonesia was alone in the region in having corruption play a significant role in business. As Ross notes, corruption in Indonesia had been persistently high for decades, and he even argues that there were good reasons to think that corruption declined between 1980 and 1997.69 However, when the crisis set in, the perception in the international capital markets—and this, we will see, mattered more than anything else—was that the country’s most glaring problem was “KKN”—korupsi, kolusi, dan nepotisme (corruption, collusion, and nepotism).70 Perhaps the most damaging effect of the corruption was that it placed in question the underlying soundness of the state-owned institutions because the Suharto regime had influenced their lending decisions over the years to funnel loans to favored businesses.71

The US Treasury, for one, believed corruption to be a central factor. As Robert Rubin, US Treasury Secretary at the time, has noted,

“As financial turmoil moved across the region, the pervasive corruption and crony capitalism that helped to shore up Suharto’s support came under closer scrutiny. Political and family connections were all-important in business.... Public money was siphoned from the budget for projects that enriched family and friends. Officially sanctioned monopolies in plywood, cars, and cloves—used in cigarettes and a mainstay in Indonesia’s economy—channeled money into corrupt hands.”

---

69 Ibid., p. 9.
70 Bluestein, p. 90.
71 Ibid., p. 94
Foreign investors and creditors who were now fleeing the country called for fundamental reform to put the economy on a sounder footing.\textsuperscript{72}

As Massar, Lee et al explain, by 1997, it was widely believed that a partnership with one of the Suharto children was an essential prerequisite for winning major contracts from the Indonesian government. Indeed, many multinational companies operating in Indonesia, including AT&T, General Electric, Hopewell and Siemens, used companies controlled by the Suharto children as agents or joint venture partners. Members of the Suharto family were often given shares in foreign ventures in Indonesia, from which they collected substantial dividends, without paying for them.\textsuperscript{73} The “all-in-the-family” corruption reached extraordinary levels, and was widely made use of by multinationals investing in Indonesia:

“Suharto’s eldest daughter had interests in such fields as telecommunications, infrastructure development and banks. She and her brother Sigit, owned 32 percent of Bank Central Asia, one of Indonesia’s largest private banks. The bank was controlled by Suharto’s close friend, 83-year-old billionaire Liem Sioe Liong, whose main vehicle, the Salim Group, was Indonesia’s largest private company. Tommy Suharto, the Youngest Suharto child, dominated the national clove monopoly which had had to be rescued by the government in 1990 at a cost of $350 million. … Tommy’s most publicized – and criticized – concession was for the development of the national car, the Timor … Suharto’s second-oldest son, Bambang, formed the conglomerate Bimantara, Indonesia’s largest Muslim-owned conglomerate. Bimantara was first given the monopoly in the plastics industry, and later diversified into electronics, shipping, telecoms, infrastructure …. Bambang had as investors or joint venture partners major companies such as Deutsche Telekom, Siemens, Hyatt and Hyundai.”\textsuperscript{74}

\textsuperscript{73} Massar, Lee et al, p. 5.
\textsuperscript{74} Ibid., p. 6.
A highly centralized system of patronage and corruption was set up, with investors who signed major government contracts typically paying kickbacks of eight to ten percent to Suharto through his wife or half-brother. Many companies also reportedly gave equity in their firms, for a fraction of the market value, to Suharto allies in the military, Suharto’s family members, or Suharto’s ethnic Chinese business partners. In return, the firms would receive “preferential access to government licenses and contracts and protection from bureaucratic asphyxiation.”

The IMF, in its own assessment of the crisis in Indonesia concedes that “Indonesia’s vulnerability to crisis was greatly increased by the increase in corruption and its changing nature.” The IMF’s emphasis on the changing nature of corruption is especially important since corruption was not new to Indonesia, nor unknown to foreign investors or the IFIs. But as is familiar from other examples of authoritarian regimes losing any sense of restraint or sobriety in their terminal stage (Iran under the Shah being one), the very nature of corruption in Indonesia was transformed in the nineties. Previously, “corruption in Indonesia was akin to a tax on the cost of a project, charged by and paid through established channels to maintain the stability of the political system.” However, in the 1990s, empire-building by the President’s children created an “ever-widening system of deliberate rent-creation for the well-connected, including the creation

---

75 Ross, p. 19.
77 Ibid., p. 64.
of monopolies and monopsonies, and exclusive rights to large industrial or infrastructure projects, such as the National Car project.”

Ross notes that the historical, less malignant, nature of Indonesian corruption – less tied to the Suharto family and less damaging to the overall economy – was even present during the first four months of the 1997 crisis, where, like in earlier crises, “Suharto placed the long-term health of the economy ahead of his short-term family interests; in September he adopted fiscal and tariff measures that hurt the interests of his inner circle … and on November 1, his finance minister closed sixteen ailing private banks, including three that were partially owned by the Suharto family.” Beginning in November, however, that changed. Suharto reinstated fifteen major government projects he had postponed in September; all of them involved relatives or close associates. In addition, Suharto’s second son, Bambang Trihatmodjo, who partially owned one of the closed banks, was allowed to purchase the license of another bank and shift the assets of his closed bank into it. The case of Bambang’s bank, in particular, had a crushing impact on the credibility of the government and its willingness to reform its practices.

Perhaps the best measure of the incurable rot in the Indonesian system at the end of the Suharto regime can be found in an anecdote recounted by Singapore’s elder statesman, Lee Kuan Yew, who on Christmas Day 1997, at the height of the crisis, together with Singapore’s Prime Minster Goh Chok Tong, met with Suharto’s eldest daughter. Lee told her that to restore investor confidence in the Indonesian economy she

---

78 Ibid., p. 64.
79 Ross, p. 21.
80 Ibid., p. 22.
and her siblings would have to curtail their business interests. “I asked her point-blank whether she could get this message understood by her siblings,” Lee later wrote. “She answered with equal frankness that she could not.”

*The Market-Dominant Minority*

Suharto’s family interests side, nothing defined the largest, most corrupt conglomerates more clearly, or more damagingly, than that they were almost all Chinese-owned. As Amy Chua observes in her important work on “market-dominant minorities,” the Chinese minority in Indonesia controlled approximately 70 percent of the private economy, while constituting less than 4 percent of the population. All of Indonesia’s billionaires were ethnically Chinese, and almost all the country’s largest conglomerates were owned by Sino-Indonesian families. The major – and, as we have seen, in the nineties entirely predictable -- exceptions to this rule were companies owned by the children of Suharto, which themselves depended on state favors and Chinese entrepreneurialism.\(^2\)

Due to the economy’s reliance on ethnic Chinese financiers, however, the Suharto regime was even more vulnerable to capital flight than similar regimes elsewhere. The Chinese had flourished economically through their patronage ties to Suharto, but they and their firms faced hostility from the population at large, and periodic anti-Chinese riots.\(^3\)

---

\(^1\) Cited in Ross, p. 22.
\(^3\) Ross, p. 19.
As a consequence, the Chinese were among the first to start fleeing Indonesia, beginning with their funds. The resulting $40 to $100 billion capital flight, almost all Chinese-controlled, played an essential part in the overall economic calamity that befell the country.\(^{84}\)

Among the majority Indonesian population, there was little doubt that the Chinese had a significant part in this national calamity, if they had not actually caused it. As his regime was coming to an end, even Suharto realized that the Chinese business community, on whom he had relied for decades to finance both personal and state projects, was considered a hated minority, and thus a liability. Toward the end of his rule, Chua observers, he began to distance himself from the Chinese, publicly castigating them for their “greed” and warning them of the dangers of ethnic unrest. It was too late, however. “Suharto’s resignation in May 1998 was accompanied by an eruption of vicious anti-Chinese violence… For three long days, terrified Chinese shop owners huddled behind locked doors while screaming Muslim mobs smashed windows, looted shops and gang-raped over 150 women, almost all of them ethnic Chinese. In the end, over two thousand people died.”\(^{85}\)

The violence even reached a point where China, having stayed aloof, went so far as to formally indicate its concern to the Indonesian government. While most wealthy Sino-Indonesians were able to escape to Singapore and other regional capitals, many are

\(^{84}\) Chua, p. 45.  
\(^{85}\) Ibid., p. 45.
still, to this day, yearning to return, and are still, among ordinary Indonesians, often considered unwelcome.

**Politics and Geopolitics**

Finally, in piecing together the elements of the “perfect storm” that struck Indonesia in 1997-1998, one cannot ignore the fact that country went through a historic political transformation during this period. Nor can one discount Indonesia’s geopolitical significance, and the degree to which it weighed on the minds of the officials of the IMF and the US Treasury. David Hale has noted, in this context, that “great economic crises do not occur in political vacuums.”

The Suharto regime, after thirty years of authoritarian, yet economically successful rule, put the fundamental contract between itself and the people of Indonesia to the test during the crisis, and did not survive it. The crisis became intensely political, as the IMF later noted, following the illness of the President in early December, making crisis management even more difficult.

“Particularly, between December 1997 and the spring of 1998, while it was apparent that the first program had failed, political issues related to the succession of President Suharto and growing social unrest made it difficult to design a credible alternative.”

Indeed, as Jeffrey Sachs and Wing Thye Woo suggest generally about such cases, “political stability, not economic restructuring, is the over-arching factor in restoring economic growth and determining future international competitiveness. Without

---


resolution of the big political conditions, economic reforms not only cannot proceed rapidly, they also cannot produce benefits that are close to their potential levels.” And finally, as Steven Radelet and Woo point out, “Suharto’s increasing tendency toward an “all-in-the-family” approach to economic and political matters discredited him considerably within his core constituency, the army and the bureaucracy. When the Asian financial crisis, which brought financial insolvency to the business elite and economic difficulties to the urban professionals, had revealed that the aging Suharto had become an incompetent manager, there was massive withdrawal of political support by the upper and middle classes, and the factionalism within the army and the civilian bureaucracy spun out of control. The Indonesians … did not have the option of expressing their outrage at gross incompetence through the ballot box, so they expressed their outrage in the only form available to them – a social explosion that produced the economic meltdown.”

As the world’s largest Muslim nation, Indonesia’s crisis caused the U.S. State Department, the Pentagon and the National Security Council to worry about the political implications of what was happening there. There were fears of a further deterioration of the situation leading to radicalism, and greater anti-Americanism as a consequence. There was a strong belief that a stable, strong, and unified Indonesia had helped keep Southeast Asians at peace with one another and with China; a weak and fractured

Indonesia might generate tensions that would draw China into a conflict. Suharto’s authoritarian mode of governing, which included jailing dissidents and brutally quelling civil disturbances, had, as Blustein notes, raised concerns on human rights grounds, but the regime’s secular nature had, it was widely believed, helped keep the peace in a nation of widely disparate ethnic groups – more than 300 of them, by some counts – that included Hindus, Christians, Buddhists and animists.\textsuperscript{90} Hale observes that if civil war were to break out in Indonesia, it would disrupt the 40 percent of the world’s shipping – including energy supplies for Japan and electronic goods for the entire world – that passes through its waters.\textsuperscript{91}

The US Treasury, within a short period of time, concluded that a change in economic policy alone wouldn’t do much to convince investors to bring their money back into the country. Funds would return to Indonesia only if people felt assured that the country afforded a stable long-term environment, both in political and economic terms. The conditions for such stability were “obviously not present in a country with a history of violent political transitions and no rule of law, run by a seventy-six-year-old autocrat whose hold on power was looking increasingly shaky, and with little consensus about the choice of his successor.”\textsuperscript{92} Reinforcing the Treasury’s view was the assessment that unlike the crisis in South Korea – a much larger economy – Indonesia’s meltdown appeared to pose little risk to the global financial system as a whole. However, the Treasury’s new stance sparked an uproar at the State Department and the Pentagon and among some at the NSC, who were “viscerally opposed to anything that smacked of

\textsuperscript{90} Blustein, p. 208.
\textsuperscript{91} Hale, p.13.
\textsuperscript{92} Blustein, p. 228.
trying to undermine Suharto. … Even if Suharto’s ouster were desirable, any move that appeared to be encouraging it would surely prove destabilizing, with the Indonesian president circling the wagons and turning antagonistic toward the United States.”93

Again, it is useful to cite Robert Rubin as an insight into the deliberations within the US government at the time, particularly when it came to the multi-dimensional nature of the challenge.

“Our view at Treasury was that Mondale [who would be meeting with Suharto as a Special Presidential Envoy] should be as direct as possible with Suharto and tell him his government didn’t have much of a future if it didn’t become serious about economic reform. The State Department worried about the danger of appearing to withdraw our support from a crucial ally. Suharto was seen as the only glue holding a fragile country together; Indonesia falling again into chaos or civil war was a real danger. The foreign policy team also felt that we risked turning Suharto hostile to the United States by insisting he meet strong conditions. This is the kind of complexity that arises in dealing with the wide range of issues relating to crisis response. Persuading countries to adopt good policies and improve governance is a vast challenge in itself. But when doing so touches foreign policy and national security goals, that difficulty greatly increases. (emphasis added)"94

This, then, was the larger context in which the international financial institutions, led by the IMF, and influenced greatly by the US treasury, confronted the crisis in Indonesia and decided to intervene with a series of measures – none of which ultimately saved the country from a disastrous financial crisis with lasting impact on Indonesia’s social and economic development. As the IMF later acknowledged, “the exceptional severity of the Indonesian crisis [was] in large part a reflection of the confluence of

---

93 Ibid., pp. 229-230.
94 Rubin, p. 248.
economic and political crises, which limited the ability of conventional policy tools to address economic problems."

\textit{The Meltdown and the Intervention}

Even conceding the impediments to economic growth and stability posed by factors such as corruption, political change, and short-term debt, the Indonesians could be forgiven for being surprised by the speed with which they were suddenly held up as a poster child for all that was wrong with the Asian model. Indeed, a 1994 World Bank noted that Indonesia's economic performance “far surpassed that of countries endowed with similar assets and subject to the same shocks,” and asserted that much of the success was due to the government of President Suharto. Specifically, the World Bank praised the government’s “active exchange rate management”, “prudent management of publicly guaranteed external debt”, “willingness to implement bold measures and comprehensive market-oriented reforms.”

Yet none of these policies were able to shield Indonesia from the effects of the loss of confidence which began as a consequence of the contagion from the Thai decision to devalue the baht on July 7, 1997. As the authorities found themselves increasingly unable to halt the drop in the value of the currency – and the catastrophic consequences for the companies and banks holding large short-term debt positions in foreign currencies – they turned to the IMF for help. As the IMF later pointed out,

\footnote{IMF, “IMF and Recent Capital Account Crises”, p. 61.} \footnote{Cited in Ross, p. 5.}
“The weak banking system proved highly vulnerable to external shocks. Once the Thai crisis prompted a reassessment of potential risks throughout the region, foreign investors began to pull out of Indonesia, thereby drying up the previously plentiful source of low-cost financing to the corporate sector. The heavily indebted corporate sector found itself facing liquidity problems, which were then compounded by the sharp exchange rate depreciation that raised the cost of servicing foreign debt. Conglomerate after conglomerate stopped servicing their loans, as the value of foreign currency debt doubled and then quadrupled in value. Foreign lenders rushed to close their exposure to Indonesia. At the time of the crisis, the banking system thus faced a huge portfolio of potential NPLs.”

On 31 October, the IMF announced a $23 billion package, conditioned on economic reforms in three areas: first, restructuring in the financial sector; second, structural reforms were to be implemented to enhance economic efficiency and transparency; third, the rupiah was to be stabilized by retaining a tight monetary policy and a flexible exchange rate policy; and fourth, fiscal tightening.

Over the next two months, a combination of investor panic, general instability and non-implementation by the Indonesian authorities of the measures required under the agreement caused a deep rift between the IMF and the Suharto government. This rift culminated on 6 January, 1998, when Suharto presented a budget that breached the IMF conditions by failing to end subsidies, and failing to end monopolies. While the authorities believed that going any further would precipitate greater, and possibly incontrollable, social unrest within the country, the international capital markets saw the budget as a test of Indonesia’s seriousness about reform – a test that Suharto failed. After an emergency meeting with the IMF deputy managing director on 11 January, Suharto reversed himself and agreed to a broad array of reforms. These were the core of the 50-

---

97 IMF, “IMF and Recent Capital Account Crises,” p. 64.
98 Massar, Lee et al, p. 8.
point letter of intent signed by Suharto in the presence of Camdessus. While the markets initially reacted positively, the good news did not last. Nothing that Suharto did could reverse the slide in confidence. Suharto himself, it appeared, was becoming the principal source of financial and economic insecurity.

Ironically, however – and indicative of the downward spiral the country confronted -- the only thing worse in investors’ minds than Suharto in power was Suharto out of power. On January 19, rumors began to circulate that Suharto would name B.J. Habibie as his vice president for his upcoming term in office. Habibie was viewed by investors as an “economically naïve, big-spending technocrat”, and the rupiah dropped fourteen percent from January 19 to 21 on rumors of Habibie’s selection. When the rumors were confirmed on January 21, it fell an additional forty-three percent over the next twenty-four hours.99

By the end of January the Indonesian economy was in serious distress. All but 22 of the 286 companies listed on the Jakarta stock exchange were technically bankrupt. The economic collapse, coupled with anti-Chinese riots, led much of the ethnic Chinese business class to flee the country.100 In April, Indonesia’s economic collapse helped fuel student-led demonstrations on Java, Sumatra, Bali and Sulawesi; in May, the protests grew dramatically in response to an IMF-mandated plan to lift fuel and utility subsidies and the shooting deaths of student demonstrators. On May 21, Suharto was forced to step

100 Ibid., p. 24.
down when members of his own cabinet, and longtime loyalists in the military and parliament, called for his resignation.

_Banking Crisis_

Central to reforming the Indonesian economy and setting its finances on a more stable course was banking reform – an area of concern highlighted by the IMF even before the crisis. Afterwards, in a paper titled “The Boom, Bust, and Reconstructing of Indonesia’s Banks,” the Fund pointed to three main factors which contributed to the vulnerability of the banking sector in the period leading up to the crisis. First, after comprehensive reforms in 1988, a rapid expansion of the banking sector took place without the necessary strengthening of prudential regulations and central bank supervision. Second, the high concentration of ownership in the banking sector had led to weak corporate governance of banks. Third, the economic boom and increased international financial integration in the 1980s amplified the structural vulnerability of Indonesia’s financial system.\(^{101}\)

Poor corporate governance, combined with a concentration of ownership by those close to the center of power, led to what the Fund calls “imprudent lending” because it was believed banks were “too big to fail” or were connected to powerful groups and would be bailed out by the government. This, in turn, created a situation of “moral hazard” that contributed to the risky behavior of banks and excess capacity in the

---

sector.\textsuperscript{102} As Ross points out, the flight of capital and the drop in the rupiah’s value trapped Indonesia’s central bank between two conflicting roles: as a lender of last resort, it was under pressure to rescue the financial sector by providing liquidity (which would expand the money supply); yet as a defender of the currency, it also had an interest in maintaining the value of the rupiah (which would require a tighter money supply).\textsuperscript{103}

Finally, the impact of corruption was perhaps the most devastating on the banking sector. Generally speaking, banks affiliated with large conglomerates owned by the well-connected tapped the large pool of household savings and used the deposits to fund their own affiliated firms, often in risky or questionable ventures. Many of the loans were never repaid, while the owners paid themselves high interest rates on their deposits.\textsuperscript{104} In addition, “losses” of the banking system … turned out to represent transfers to conglomerates run by the well-connected.\textsuperscript{105} The extent of delinquent loans, together with the high level of connected lending in many of the private banks, illustrated the degree to which in the pre-crisis period the state banks had been used as vehicles for directed lending to noncommercial ventures, and private banks as vehicles for channeling deposits to the owners.\textsuperscript{106} Tackling the crisis of the banking sector head-on became a precondition for restoring confidence and reversing the flow of capital that was destroying the value of the currency, and making the debt-burden on the economy as a whole unsustainable.

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{102} Ibid., p. 8.
\item\textsuperscript{103} Ross, p. 8.
\item\textsuperscript{104} IMF, “IMF and Recent Capital Account Crises”, p. 63
\item\textsuperscript{105} Ibid., p. 63.
\end{enumerate}
\end{footnotesize}
Bank Closures

And yet, there is near-universal consensus – including the IMF – that the Fund’s handling of the banking crisis made matters worse, not better. A combination of lack of appreciation of the macroeconomic consequences of the banking crisis, the proliferation of structural, governance-related conditions in the Letters of Intent which served to dilute the importance of banking reform, and the absence of a blanket deposit guarantee served to make the closing of a relatively small number of banks by the Fund the trigger for a broad-based run on the Indonesian banks. While the closings of the most insolvent or nonviable financial institutions were used initially to stem rapidly accumulating losses and central bank liquidity support, the experience of Indonesia showed that in a systemic crisis bank closings can lead to runs on other banks, if not accompanied by proper information, strong overall economic management, and a blanket guarantee.\(^\text{107}\) As Sachs and Woo point out, closing the bad banks without depositor insurance spread the financial panic to the good banks.\(^\text{108}\)

Today, as noted, the IMF acknowledges these errors. It concedes, in its own words, that the “the Indonesian banking sector program … initially suffered from the lack of a comprehensive strategy and the failure to communicate the logic and outline of the policy to the public. As a result, the closure of 16 banks in November 1997, with subsequent reversals exacerbated, rather than dampened, the crisis. … The issue of whether a blanket guarantee, instead of the partial guarantee actually offered, should have


\(^{108}\) Sachs and Woo, p. 21.
been introduced in Indonesia in November deserves careful consideration.”\textsuperscript{109} There was, at the time of the crisis, a consensus between the authorities and the IMF staff that a blanket guarantee would not be desirable on grounds of both fiscal cost (emphasized by the Indonesians), and moral hazard (emphasized by the IMF).\textsuperscript{110} Since then, as the IMF acknowledges today “many, including, IMF staff, have increasingly come to accept the view that the decision not to install a blanket guarantee was the critical mistake of the November 1997 bank closure.”\textsuperscript{111}

Indeed, in a country where the lack of transparency and reliable information was a key source of insecurity, the lack of public announcement and openness about which banks were closed and why led to a public perception that all banks were potentially insolvent. Domestic investors transferred deposits from private banks to state banks in a flight from quality to safety. Many also transferred funds to foreign banks or exchanged rupiah for dollars and repatriated their funds. Ironically, the decision to close on bank closely tied to one of Suharto’s sons – while showing a willingness to attack the problem of corruption involving the ruling family directly – had the opposite effect on domestic confidence. Among Indonesians, the reaction was that if a Suharto-connected bank wasn’t safe from being shut down, then no bank was safe. To compound the problem, having lost domestic confidence with the initial decision, the subsequent non-implementation of the decision precipitated a loss of confidence \textit{internationally} when that same son of Suharto, Bambang, was allowed to transfer the assets of the now shuttered bank to a smaller bank and continue business under another name.

\textsuperscript{109} IMF, “The IMF and Recent Capital Account Crises”, p. 5.
\textsuperscript{110} Ibid., p. 75.
\textsuperscript{111} Ibid., p. 75.
This dilemma is best illustrated in the reflections of Sudradjad, who as Indonesia’s Central Bank governor at the time, had resisted many of the bank closures, and then witnessed a rapid acceleration of the bank runs. “From the foreign market’s point of view, the policy was credible because even banks owned by people close to the Suharto family were being closed. But domestically, people said, “Wow, if more banks are weak, and even banks belonging to people in the president’s family are being closed, then there must be others next. It may sound crazy, but that’s what I encountered.”  

**Currency Board**

One episode from the crisis serves to further illustrate the relationship between the IMF and the Suharto government as it sought to find its way out of the crisis, with some degree of residual sovereignty. As the value of the rupiah continued to plummet, and as Suharto increasingly lost faith in the prescriptions of the Fund, he began to look for alternatives. One such alternative came in the form of a currency board proposal provided by an American academic, Steven Hanke. Within days of proposing the idea, Hanke was appointed to a position of Special Economic Advisor to the government, and was given private audiences with Suharto.

Suharto’s dilemma, as Massar, Lee et al note, was that the currency board seemed to offer the chance that the currency could be stabilized, and that the economy might be restored under less volatile circumstances. On the other hand, should Suharto defy

---

112 Cited in Blustein, p. 107.
international opinion he would lose the support – and money – of the IMF, and perhaps the ability to implement the currency board in the first place, if confidence eroded further and he was punished by the markets.\textsuperscript{113}

While many Indonesians supported the currency board as a way to restore confidence in the rupiah – particularly when the measures proposed by the IMF seemed to be failing – international observers and analysts were almost uniformly opposed to the idea, believing that “the currency board would not only fail, but lead to further economic hardships.” A World Bank spokesman said: “This is not something we recommend at this time,” and US Treasury Secretary Rubin said, with characteristic understatement, “I think that there are a lot of issues that need to be worked through before you get to the question of whether or not you should have a currency board.”\textsuperscript{114}

The IMF’s reaction, while first muted, soon became very direct: In a letter dated 11 February, Michel Camdessus said that “[i]n the present circumstances … if a currency board proposal were adopted, we would not be able to recommend to the IMF Board the continuation of the current programme because of the risks to the Indonesian economy … This would be a very unfortunate development, as it would shrink even further the reserve basis for the currency board and further undermine its very slim chance of success.”\textsuperscript{115} Given that the IMF was, just as importantly, a gatekeeper for private investment flows to Indonesia, Suharto was forced to back down from the idea and return, in practice, \textit{if not in spirit}, to the prescriptions of the IMF.

\textsuperscript{113} Massar, Lee et al, p. 12.
\textsuperscript{114} Ibid., p. 11.
\textsuperscript{115} Cited in Massar, Lee, p. 1.
This one episode from the crisis crystallizes the dilemmas of conditionality and intervention, and makes clear, too, that unless there is genuine consent on the part of the borrower – an independent, sovereign assessment that the prescriptions of the Fund are the rights ones in the view of the country’s own leadership – it becomes very difficult to sustain an effective process of reform.

**Conditionality, Sovereignty and Ownership**

Any assessment of the Indonesian crisis and its lessons for sovereignty has to address the key question of conditionality, including its relation to what is referred to as “ownership” of adjustment programs on the part of borrower nations. The lines here are sharply drawn, not only theoretically in terms of what is appropriate in terms of intrusive conditionality, but also empirically in terms of the trade-off between conditionality and ownership, and how effective programs that ignore the question of ownership in rigid pursuit of theoretically appropriate conditions can be. It is equally important to consider how such a triple crisis of confidence can emerge, with the markets losing confidence in the government’s reforms; the government losing confidence in the IMF’s proposals; and the IMF losing confidence in the government’s ability to carry out the necessary reforms.

In order to assess the many facets of this question, it is useful to look at the IMF’s own conclusions in the aftermath of the crisis. Following this, we will examine this question through the views of three of the key participants in the crisis – Joseph Stiglitz, then Chief Economist of the World Bank; Robert Rubin, then Treasury Secretary of the
United States; and Boedino, then a principal member of the Indonesian economic team advising Suharto – before drawing some preliminary conclusions about the trade-off between conditionality, sovereignty and “ownership” in financial assistance programs.

The Origins of Conditionality

While the IMF now recognizes that it “misjudged the extent of ownership at the highest political level and underestimated the resistance to reform likely to be posed by vested interests”116, its own history should have held cautionary lessons about the dangers of too much conditionality, too little “ownership”, and too violent an intrusion on the sovereignty of states. In fact, the IMF’s managing director in the late 1950s identified the problem succinctly, though somewhat disingenuously, when referring to the ability of borrower states to influence the terms of the loans:

“[S]uch programs can only succeed if there is the will to succeed in the countries themselves … The IMF does not impose conditions on countries; they themselves freely have to come to the conclusion that the measures they arrange to take – even when they are sometimes harsh – are in the best interests of their own countries.”117

There is, as we have seen, rarely anything “free” about the decision of a sovereign state to seek shelter under the umbrella of IMF conditionality, nor is it something most countries particularly enjoy. To take one example from the Asian crisis, the Thai government was initially adamant in its refusal to accept the IMF’s help, since it did not

---

want to subject its economic policy-making to IMF approval. And there was, in fact, no way for the Fund to impose itself on Thailand, or any other country. Not in principle, at least. As Blustein notes, “as an international organization whose members are sovereign nations, the IMF is forbidden from even sending a mission to a country unless it has been invited by the country’s authorities.”

In practice, the reality is more complicated. In the case of Indonesia, going to the IMF was necessary not only to obtain funds. Even more importantly, it was the only way to send a signal to the capital markets of responsible governance, and a willingness on the part of Suharto’s government to tackle the underlying problems that were causing the loss in confidence which had such a ruinous impact on capital flows. And to get this support, Indonesia would have to accept the conditions attached to the bail-out package.

There is, of course, as Mohsin Khan and Sunil Sharma point out, some form of conditionality present in all borrower-lender relationships – the key to the ability to borrow is the ability to pledge income back. Countries in need of IMF loans generally do not possess internationally valuable collateral. If they did, they could use it to borrow from private lenders and would not require resources from the IMF. In addition, there is a classic “principal-agent” problem in sovereign lending, in this case with the IMF acting as principal and the Indonesians as agents. Therefore, these authors note:

IMF conditionality can be viewed as a complex covenant written into the loan agreement. The policy prescriptions contained in IMF-supported programs

---

118 Blustein, p. 51.
119 Khan and Sharma, p. 6.
essentially serve to provide the safeguards that the country will be able to rectify its macroeconomic and structural imbalances, and will be in a position to service and repay the loan. The conditionality associated with IMF-supported programs can therefore be thought of as a substitute for collateral.\footnote{Ibid., p. 6.}

Viewing conditionality through this perspective – as simply another form of collateral – makes clear how fraught this question is when it comes to sovereign states. The enforcement mechanism for ensuring that borrowing countries live up to their obligations “essentially amounts to some combination of moral suasion, maintenance of the borrower’s reputation, peer pressure, and the threat of being shut out of international capital markets.”\footnote{Ibid., p. 8.} In the case of Indonesia, as we have seen, these threats were real, most glaringly in the example of the short-lived currency board proposal.

Finally, compared to private lenders, the IMF faced what Khan and Sharma refer to as a “Samaritan’s dilemma.”\footnote{Ibid., p. 8.} Given its mandate, structure and rules, the IMF is not always credible – nor, paradoxically, in the eyes of its critics, should it be credible – when threatening severe consequences in the case of non-performance. Yes, in order to provide the proper incentives, the Fund has to place strict conditions, and promise severe penalties if the covenants are violated. However, is the Fund really able – and should it in fact – go through with imposing penalties on countries, the consequences of which are mostly borne by the population, and the effects of which can spread through contagion?

The deeper, underlying economic argument about the nature of conditionality in the Indonesian case has revolved around the degree to which the Fund departed from
traditional macro-economic concerns -- and conditions -- to demand changes in
governance, transparency, and socio-political structures that went far beyond traditional
programs.

*Structured Conditionality*

Indonesia – and most specifically, the 50-point 15 January 1998 Letter of Intent
signed by Suharto under Camdessus’s watchful eyes – have since become models for the
kinds of structural conditionality programs that to those on one side of the debate are
considered essential to restoring confidence, if *structural factors were critical to the
crisis in the first place*; and to those on the other side as irrelevant, and damaging to the
extent they distract the country and the markets from reforms that actually have a bearing
on the country’s macroeconomic health. Khan and Sharma point out that, from an
empirical point of view, there is no “compelling evidence that programs with a greater
number of structural conditions have been more successful.”

The IMF, in its
subsequent accounts of the crisis, has sought to place responsibility for the structural
conditions on “the major shareholders” (read: the United States). To this, Robert Rubin
concedes that many of the changes that the IMF pushed were “outside its usual realm of
expertise on exchange rates, interest rates, and government finances. And in hindsight,
many people involved agree that there were too many conditions spread across too many
different areas. Expecting the government to fix so many problems at once just wasn’t
realistic and probably blurred focus on the most urgent ones.”

---

123 Khan and Sharma, p. 21.
124 Rubin, p. 247.
The litany of demands in the January 15 read, in the words of one observer, like “the World Bank’s wish list for reforming every rotten, wasteful distortion in the Indonesian economy.” Subsidies to plants, projects and firms run by members of Suharto’s family would be eliminated; monopolies controlled by cronies of Suharto would be disbanded; and most famously, the “National Car Project” run by Suharto’s son Tommy would lose its subsidies, and his control over the clove trade would be abolished. While the Fund was adamant that restoring confidence required precisely these kinds of steps, the question of Suharto’s commitment was always looming, as was the question of the macroeconomic impact of these steps. In a spirit similar to Suharto’s flirtation with Steven Hanke and the currency board proposal, Suharto reached out to the former Chairman of the US Federal Reserve, Paul Volcker, for advice. He, for one, publicly questioned the relevance of structural conditionality of the kind included in the January package, and dismissed the market deregulations in cloves, oranges, and other foodstuffs as a mere “recipe.”

As a former senior US Treasury official has remarked, “designing such programs is an art and a science, but there is far less economic science to it than psychology. There is nothing magical about a 3% budget or current account deficit, and nothing sacrosanct about 30% interest rates. And, indeed, some of the most interesting conflicts the IMF has had with countries is over which had the better idea about which symbols mattered.”

In the case of Indonesia, two principal motivations drove the Fund to insist on these conditions. First, the collapse of the November 1997 program and its conditions

\footnote{125 Interview with the author, 26 January, 2004.}
relating to bank restructuring and monetary control, and the inability of the initiatives to halt the collapse in the value of the currency. Second, as contagion spread and the markets increasingly identified “crony capitalism” as a source of the problem, addressing this structural, and largely microeconomic issue, became necessary in order for the program to have credibility and demonstrate that it was willing to tackle the hard questions.

“Ownership,” Policy Reversals and Non-Implementation

For the Fund to show a willingness to face the underlying issues – and create a program of deeply intrusive structural conditionality -- was one thing. Quite another -- when dealing with a sovereign state -- was whether the government of President Suharto was even remotely as committed to overturning what it considered a successful formula of thirty years. As Khan and Sharma note in a general assessment of conditionality, “country ownership of programs, because it aligns the incentives of the lender and borrower, is fundamental. For the country, program ownership is critical because without a firm commitment from the government and other relevant constituencies, the difficult policy measures designed to correct economic problems are less likely to be implemented.”

In the case of Indonesia, the Fund ought to have been more suspicious of the speed and alacrity with which Suharto was willing accept its demands, given that he one week before had presented a budget that violated every previous commitment made to the Fund. Suharto’s about-face had, no doubt, something to do with the markets’

---

126 Khan and Sharma, p. 4.
reaction to this budget – within six days, the rupiah dropped from 5,550 to 11,200 to the dollar, a loss in value of over fifty percent.

It is, however, also possible, as Blustein suggests, that Suharto did not entirely understand what was being asked of him. “He was evidently told that the IMF program would be precautionary and that it was needed for confidence purposes. At the same time, several top members of Suharto’s economic team were confiding to U.S. and IMF officials that they wanted the Fund to impose a number of reforms they had long favored, and some of these policymakers, notably the passionately upright finance minister, Mar’ie Muhammad, favored an attack on the monopolies and subsidies that had flourished thanks to KKN.”\textsuperscript{127} In an authoritarian, patronimial state such as Indonesia, however, consent by the leader is the \textit{sine qua non}. And today, the IMF recognizes that the failure of its program – the substance of it aside – was in part related to what it diplomatically refers to as the “visible lack of political commitment to the policies promised.”\textsuperscript{128}

Finally, and perhaps most convincingly, there is the possibility that Suharto knew that the markets demanded his public commitment to structural conditionality, but that he, over time, would be able to restore sovereign control over his economy. Suharto is reported to have said in a high-level meeting of his advisers that not all agreed measures needed to be respected, and that he would “wage a guerilla war against the IMF.” Later, he expressed the view that some of the reforms violated the constitution. In February

\textsuperscript{127} Blustein, p. 101.
\textsuperscript{128} IMF, “The IMF and Recent Capital Account Crises,” p. 2.
1998, the staff of the IMF reported in a memo to management that “all of the
deregulation and liberalization measures relating to wood, cloves, BULOG, palm oil,
wholesale and retail trade, and interregional trade were being subverted by various
groups close to the President.”129

The process of getting to the January 15 agreement was marked by one reversal
after another by the government, one instance of non-implementation after another. Not
only were the measures suggested by the Fund perhaps not the rights ones, they weren’t
even being implemented. This created a dual crisis of confidence that was central to the
collapse of the economy.

Having assessed the tortuous road to the 15 January Letter of Intent – with its
structural conditionality, violations of sovereignty, non-implementation and lack of
ownership – it is useful to consider the perspective of some of the key participants in the
crisis, and explore their views on the trade-off between conditionality and ownership.
For Stiglitz, an ardent critic of the Fund and its approach generally to financial crisis
management, there is, first of all, no question that the conditions international lenders
impose for their assistance undermine national sovereignty, and thus democratic
processes. Nor is there any doubt in his mind that the true beneficiaries of the Fund’s
bail-out packages are more often foreign private sector creditors than the people of the
country which ostensibly is being bailed out. More fundamentally, Stiglitz charges that
there “is little evidence that [conditionality] leads to improved economic policy,” in

129 Ibid., p. 77.
addition to which he argues it has “adverse political effects because countries resent having conditions imposed upon them.”

For Rubin, by contrast, establishing confidence was the one and only true measure of a successful intervention – and if that demanded strict conditionality, severe violations of economic sovereignty, and overturning decades of practices, so be it. To Rubin, this does not mean that the state, generally speaking, is becoming less important. To the contrary: “The potential impact of any one country’s problems on others means that national governments matter more -- an ineffective government in one country can have a damaging impact beyond that country’s borders.” For him, “Indonesia’s escalating crisis highlighted how difficult overcoming financial turmoil can be when political, economic and foreign policy concerns are interwoven.”

Even as he concedes that the Treasury underestimated the impact of the weakening of Suharto as a consequence of the structural reforms – and the impact that in turn had on the confidence of the markets – Rubin notes that these were nonetheless the issues on the minds of foreign creditors and investors and therefore simply could not be ignored. Not even, when they had the paradoxical effect of reassuring reassure foreign investors while simultaneously alarming domestic investors: “Certain Indonesian officials themselves had identified a wide array of reforms to combat corruption, from restructuring banks to curbing key monopolies and opening up the government’s books to scrutiny. Foreign confidence now hinged to a significant degree on these reforms being

131 Rubin, p. 215.
132 Ibid., p. 243.
implemented. But such reforms could further weaken Suharto and thereby worsen domestic capital flight.”¹³³

Ultimately, Rubin does nothing to disprove the charge that the Treasury’s policies – and by extension the IMF’s – focused on restoring confidence with the markets, above all. He allows that “others argued that in focusing on confidence in this way, the IMF and we at Treasury were following the whims of the financial markets – which might be irrelevant or counterproductive – rather than focusing on fundamental problems.” But he states unequivocally that “by and large the markets tend to shine a spotlight on real economic problems, although they may exaggerate the importance of those problems at times (as well as ignoring them at other times).”¹³⁴

The question, then, becomes not one of whether to heed the call of the markets and do whatever it takes to restore their confidence, but whether IMF programs, in the absence of genuine sovereign ownership on the part of the borrower country, can succeed in doing so. Rubin’s own conclusion is telling: “The IMF’s efforts in Indonesia were widely viewed as a failure. However you apportion the blame, whether it was more Indonesia’s fault or that of the IMF working with the US Treasury and others, one central issue is that Indonesia never took ownership of reform.”¹³⁵

Perhaps the best evidence of this fatal flaw in the assistance program comes from the reflections of Boedino, the senior Indonesian economic official, who later reflected on

¹³³ Ibid., p. 243.
¹³⁴ Ibid., p. 250.
¹³⁵ Ibid., p. 250.
his experience of the crisis. He notes, in an important insight, that in the early days of the crisis, when the government decided to go for a full program with the Fund, “the expectation of many, including the President, was that the crisis would be over soon.” The disappointment, once it became clear that these steps would not suffice in ending the panic, was likely a significant impetus to the loss of political will on the part of Suharto to make the necessary changes, leading to a rapid weakening of ownership. Boedino notes that, in the mind of most Indonesians, “the patient progressively got worse after taking the medicine. From then on the President’s confidence in the program and also in the economic team appeared to wane rapidly.”\textsuperscript{136}

By the end of 1997, Boedino recounts, the “President seemed to have been determined to search for possible short cuts out of the crisis or at least not to put all his eggs in one basket.”\textsuperscript{137} (This explains, among other factors, the ill-fated flirtation with the currency board). In addition, Suharto’s disappointment with the program was fueled by a sense of feeling “pressed to accept conditionality that was repugnant to him.”\textsuperscript{138} Ultimately, to Boedino, the experience could have ended differently, had the conditionality been confined to matters that were essential for the handling of the crisis, which, in his view, would include a comprehensive banking reform, while postponing some of the structural conditions, including those relating to Suharto’s family, until “our head was above water.”\textsuperscript{139}

\textsuperscript{137} Ibid., p. 2.
\textsuperscript{138} Ibid., p. 3.
\textsuperscript{139} Ibid., p. 3.
Boedino’s perspective suggests that sovereignty, conditionality and ownership were even more complex and inter-related factors than anyone at the time imagined. Conditionality was necessary to elicit performance, which in turn could restore confidence. On the other hand, too heavy a hand on the part of the IMF, too dramatic a violation of sovereignty, had the effect of reducing ownership to the point of the government almost washing its hands of the reforms. This, in a way, can be thought of as the revenge of sovereignty inflicted on international financial institutions which ultimately could not have a sustained impact without a degree of sovereign ownership that their very own actions made impossible. A kind of “reverse conditionality” can be adduced, where Indonesia’s compliance with the terms of the agreements was conditioned on the Fund allowing a certain necessary basic degree of sovereign decision-making to exist. If the Fund could strip Indonesia of sovereignty in its demands, so, too, could Suharto deny the Fund the degree of sovereign commitment necessary for its programs to succeed.

The Centrality of Confidence & the End of Sovereignty

Fundamental to the analysis of whether the structural conditionality programs did more harm than good, addressed real problems at the micro level or diverted attention from what really mattered at the macro level, is the issue of confidence. If it can be demonstrated (and in a financial panic, it is difficult in the extreme to establish reliable causality) that what Volcker considered the “recipe” of structural conditions relating to governance and corruption did not address the concerns of the markets, then certainly, it
can be said that the January 15 Letter of Intent was over-kill of a kind that made the necessary changes harder to achieve. In that case, ignoring the governance-related structural issues would have made sense.

If, on the other hand, the lack of confidence among market participants was less tied to the crisis in the banking sector, and more reflective of a concern about “crony capitalism”, then focusing on what was considered the appropriate macro-economic areas traditionally addressed by the IMF would have been the wrong thing to do. Had the Fund decided to that, it could well have ended up accused of failing Indonesia by not realizing that in this day and age, markets are concerned about more than macro-economic issues, and are more than willing to vote a country down on governance, transparency and corruption grounds.
Chapter IV

After Sovereignty

The Indonesians financial crisis was a crisis of many levels. At its core, it was a financial panic caused by a lack of confidence leading to capital outflows destroying the value of the currency, which in turn made the high short-term debt burden unsupportable. At another level, it was a case of financial panic, caused by a sudden souring on an Asian model which had produced extraordinary, sustained growth levels, but which now seemed – in the eyes of the markets – to lack the transparency and “good governance” necessary to carry through with the necessary reforms.

At a third level, it was a triple crisis of confidence, with the markets losing confidence in the ability of the Suharto regime to address the underlying causes of the crisis; the government losing confidence in the ability of the IMF-proposed reforms to restore market confidence; and finally, the IMF losing confidence it the willingness of the government to fulfill the conditions stipulated in the agreement.

Robert Rubin has observed that “the cause of the hardship in crisis countries was not the IMF-backed programs but the crisis itself – the fact that capital was fleeing.”140 He asserts that “by and large, the IMF got it right,” and offers as argument that “what triggers an economic crisis is a loss of confidence. This results from underlying macroeconomic and structural problems, as well as an often sudden reevaluation by

140 Rubin, p. 258.
domestic and foreign investors of the attractiveness of a country as a place to put savings."

Sachs and Woo suggest that “rather than an Asian crisis, the world is experiencing a type of global crisis that reflects the rapid arrival of global capitalism in a world economy not yet used to the integration of the advanced and developing countries.”¹⁴¹ For them, the lesson is that in the new global economy, it is essential to “recognize the types of shocks that have been magnified and rendered more common by the processes of deep economic integration and of institutional harmonization that are key forces of global capitalism.”¹⁴²

Certainly, for Indonesia, the consequence of the crisis will be felt for decades to come. Even though Indonesia exited from its IMF conditional lending program at the end of 2003, and the Indonesian Bank Restructuring Agency (IBRA), created in 1998 during the Asian financial crisis to pick up the pieces from the collapse of the country’s banking sector, was finally wound up in February 2004, the crisis has wiped out a significant part of the progress against absolute poverty achieved in the last 30 years, raising the official poverty rate from 11 percent in 1996 to 40 percent in 1998. The riots in the first half of 1998 which ended the 32-year reign of President Suharto, and resulted in the burning of Jakarta’s Chinatown, have been replaced by inter-religious and inter-

¹⁴² Ibid., p. 16.
island conflicts, and there are continuing breakdowns in basic law and order on personal safety and protection of property rights.  

Michael Walzer once observed, in a discussion of the nation-state, that “the state is invisible; it must be personified before it can be seen, symbolized before it can be loved, imagined before it can be conceived.” In the case of Indonesia – an exceedingly diverse and disparate nation – Suharto was the personification of the state, his power and privilege its symbols, and his achievement in bringing prosperity and growth the source of his legitimacy. When his people saw him surrender sovereignty – however contingent, even imaginary it may have been in reality – so abjectly at the command of the IMF, the aspiration of conditionality met the reality of confidence.

From that moment on, the very loss of sovereignty (embodied in acceptance of the IMF’s terms) that was supposed to create confidence, only served to erode it further. What had been considered a (necessary and productive) trade-off between conditionality and sovereignty, in fact turned out to be a trade-off between sovereignty and confidence. It turned out that for the global financial markets, conditionality without ownership was as problematic as sovereignty and poor governance.

Indonesian sovereignty – as embodied by Suharto – was contested, compromised and conditional as never before during the financial crisis of 1997-1998. What is now clear is that sovereignty in an age of financial globalization is both more permeable and

---

143 Ibid., p. 39.
144 Cited in Ruggie, p. 157.
more resilient than it would appear. The trade-offs between conditionality, sovereignty and “ownership” in structural adjustment programs take place on many dimensions, and flow in both directions. What remains is the reality of global markets with the power to undo economies and destabilize societies which fail the test of “confidence.” No amount of sovereignty – real or imagined – can overcome this force.

Perhaps the most profound lesson of the Indonesian crisis is that the threat to sovereignty in an age of financial and technological globalization comes from the uncontrolled – and uncontrollable – judgment of global capital markets. If it were just a matter of resisting the IMF, and resisting its conditionality by withdrawing ownership or refusing to implement its conditions, it would be one thing. What is clear from Indonesia’s experience is that the IMF – no less than the Indonesian government – found itself hostage to the markets’ whim of steel.
Bibliography


Eichengreen, Barry, *Can the Moral Hazard Caused by IMF Bailouts be Reduced?* Geneva: International Center for Monetary and Banking Studies, 2000


Krasner, Stephen D., “Rethinking the Sovereign State Model”, *Review of International Studies* (200), 27


Krugman, Paul, “Saving Asia: It’s time to Get Radical”, 1998


Ross, Michael, “Indonesia’s Puzzling Crisis.” (Los Angeles: UCLA, 2001)


