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THE ASIAN ECONOMIC CRISIS AND INDONESIA'S ARDUOUS STRUGGLE TO
ACHIEVE ECONOMIC RECOVERY

by

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From boom to bust

After recovering from the economic chaos and hyperinflation of the early 1960s, the Indonesian economy since the late 1960s embarked on a period of rapid growth which in general it was able to sustain for the next three decades. The rapid economic growth and transformation which Indonesia experienced during this period transformed the country from being the '*prime economic underperformer*' among the Southeast Asian economies in the early 1960s into an emerging '*newly-industrialising economy*' (NIE) in the early 1990s. This new economic status was achieved as a result of rapid industrial growth which transformed Indonesia from a largely agrarian economy in the mid 1960s to a rapidly industrialising economy in the mid 1990s. As a result of this remarkable economic performance Indonesia, along with Japan, South Korea, Taiwan, Hong Kong, Singapore, Malaysia, and Thailand, in 1993 was classified as one of the '*high-performing Asian economies*' (HPAEs) by the World Bank in its famous but controversial report on '*The East Asian Miracle*'. (World Bank 1993: xvi).

Despite the great differences between Indonesia and the other seven HPAEs in terms of levels of economic development, standards of living, size of the economy and size of the population, and resource endowments, and historical and cultural background, it shared with the latter countries some similar characteristics which, according to the criteria set by the World Bank, qualified it as one of the HPAEs, namely rapid and sustained growth from the mid 1960s through the mid 1990s. Other developing countries have also grown equally rapidly during certain periods, but not at such high rates for such a long period. Equally important, the rapid,

sustained growth of these HPAEs was, unlike most other developing countries, accompanied by a rapid decline in absolute poverty and a relatively equal income distribution. All these HPAEs also experienced rapid demographic transitions, strong agricultural growth, and very rapid export growth. (World Bank 1996: 8; 28-40).

The rapid and sustained economic growth of these HPAEs was associated with high rates of physical investment, including high rates of private investment, high rates of investment in human capital, and high rates of productivity growth. (World Bank 1993: 8).

Certainly a remarkable feature of Indonesia's rapid economic growth during the past three decades of the Soeharto era has been the steady decline in the incidence of absolute poverty. While the estimates of the exact extent of poverty reduction in Indonesia have differed according to the use of a specific poverty line concept used by various agencies and scholars, all these estimates have yielded the same basic finding, namely that the incidence of absolute poverty in Indonesia has indeed declined since the late 1960s through the mid 1990s. In fact, in a comparative study on the performance of a number of developing countries in alleviating absolute poverty, the World Bank concluded that during the period 1970-1987 Indonesia had been the most successful among the developing countries in reducing poverty. (World Bank 1990: 45).

Throughout the early and mid 1990s the Indonesian economy kept growing rapidly at an average annual rate of 7.5 per cent. However, during this period rising criticism from concerned observers were directed at the government for tolerating the proliferation of what the World Bank euphemistically called 'common local practices' (World Bank 1997a: 1), that is corruption, mutually profitable collusive arrangements between venal senior government bureaucrats and business tycoons, and blatant nepotism by the country's powerholders. According to these critics, these abuses contributed to the perceived widening economic disparities and the corrosion of the economic and social resilience of the country.

The deterioration in the political economy of Indonesia was, amongst others, reflected in the erosion of fiscal discipline which had been a hallmark of the economic policies for the greater part of the Soeharto administration. This erosion in financial discipline was evident from the increase of off-budget public expenditures for the funding of various costly investment projects of questionable economic value. (Nasution: 1995: 3-4). On the microeconomic level various regulations and restrictions on domestic competition had been introduced which had an adverse impact on the investment climate and the economic efficiency in various sectors of the economy, as it only encouraged unproductive rent-seeking activities. Not surprisingly, in various polls

conducted by various international organisations, Indonesia consistently ranked as one of the most corrupt countries in Asia. Government officials, however, tended to dismiss these criticisms, pointing out that since the Indonesian economy was still growing at a brisk pace, the corrosive effects of corruption, if there were any, were vastly exaggerated.

Whatever misgivings international aid organisations and donor countries were having about basic weaknesses of the Indonesian economy, specifically relating to the so-called governance issues, their official statements about the economic prospects of Indonesia were generally fairly upbeat. This was clearly evident from the World Bank's annual report on the Indonesian economy, released on 30 May 1997 which, based on the good performance of the Indonesian economy during the period 1991-1996, forecast, with some qualifications, a similar robust average growth rate of 7.8 per cent for the remainder of the 1990s. (World Bank 1997a: 29).

However, by late July 1997, barely two months after the release of the World Bank report, perceptions about the Indonesian economy changed suddenly for the worse, as the Indonesian *rupiah*, in the wake of the depreciation of the Thai *baht*, the Philippine *peso*, and the Malaysian *ringgit*, also started depreciating, first gradually but then increasingly rapidly, as investor funds were scrambling to reduce their exposure to Indonesia. Unlike the depreciation of the Thai *baht* and the Malaysian *ringgit* which were initially triggered by the flight of international capital, followed subsequently by domestic capital flight, in Indonesia the *rupiah* depreciation was initially triggered by the flight of domestic capital, but subsequently followed by the flight of international capital. Apparently the flight from Indonesia of domestic capital was caused by the fact that a number of Indonesian businessmen were losing their confidence in the prospects of the Indonesian economy. (Johnson 1998: 12).

As Indonesian companies heavily indebted to foreign creditors rushed to cover their external debts, much of it unhedged and short-term, by purchasing foreign exchange in large quantities, the *rupiah* further depreciated. In the face of persistent market pressures on the *rupiah*, the Bank of Indonesia floated the *rupiah* on 14 August 1997. This measure, however, further increased the downward pressures on the *rupiah*, as more and more companies saddled with foreign loans, much of it short-term and unhedged, attempted to purchase foreign exchange. Foreign exchange supplies, however, had grown increasingly scarce as foreign creditors were becoming reluctant to lend to Indonesian companies. (World Bank 1998:1.4).

As the *rupiah* continued to depreciate, the Indonesian government on October 13, 1997 turned to the International Monetary Fund (IMF) for financial assistance to help Indonesia

solve the currency crisis. In return for a standby loan offered by the IMF, the Indonesian government pledged to implement a comprehensive reform program, involving a commitment to stick to sound macroeconomic policies, to restructure the financial sector, and undertake structural reforms. It was hoped that the availability of a large IMF standby loan, backed by a credible economic reform program sanctioned by the IMF, confidence in the *rupiah* would be restored. (Sadli 1999: 17).

Thus, just like at the beginning of its reign in 1966, the Soeharto government had once again come under the tutelage of the IMF. However, while in 1966 the IMF assistance was primarily intended to lower inflation (Booth 1998a: 178), in 1997 IMF involvement was sought to stem the erosion of market confidence in the *rupiah*.

The IMF package was to be implemented over a three-year period and to be tightly monitored by the Indonesian government, assisted by experts from the IMF, the World Bank, and the Asian Development Bank (ADB). (Soesastro & Basri 1998: 18). In addition to the IMF, World Bank, and ADB loans, several countries also offered financial assistance to help strengthen the *rupiah*. The IMF rescue package provided for a US\$ 43 billion standby loan, including a US\$ 10 billion standby loan from the IMF itself, and an additional US\$ 4.5 billion from the World Bank, US\$ 3.5 billion from the Asian Development Bank (ADB), and additional contingency loans from bilateral sources, including US\$ 5 billion each from Japan and Singapore, US\$ 3 billion from the U.S., US\$ 1.2 billion from Brunei Darussalam, and US\$ 1 billion each from China, Malaysia, and Australia. (Soesastro & Basri 1998: 16).

The first step which the Indonesian government took to implement the agreed-upon IMF-mandated reform program was in the field of financial restructuring. This step was considered necessary, as the weak banking system, saddled with large, non-performing loans, had been a major factor in causing the crisis. To this end the Indonesian government closed down 16 private insolvent banks, including some banks owned and controlled by the President's relatives and business cronies. The objective of this radical step was to show the government's commitment to deal decisively with financially troubled banks. However, instead of restoring public confidence in the banking system, the liquidation of the 16 banks led to a further erosion of public confidence in the banking system, as reflected by a rush of the public to withdraw their deposits from private banks. This, in turn, forced Bank of Indonesia, the central bank, to provide large amounts of so-called liquidity credits to the remaining private banks to prevent their collapse. Hence, the crisis faced by highly indebted companies was now aggravated by a banking crisis. (World Bank 1998: 1.6). Actually, both the IMF and the Indonesian government are to be criticised for having overlooked the danger

of summarily liquidating a relatively large number of private banks without realising the adverse impact on public confidence of liquidating banks in a country without a proper deposit insurance scheme.

By early January 1998 the steady depreciation of the *rupiah* had turned into a runaway, free-fall depreciation unprecedented in world economic history. While one US dollar was worth Rp. 2,400 in early July 1997, by late January 1998 its value vis-a-vis the US dollar had tumbled to Rp.17,000. Hence, over this period the *rupiah* had depreciated by over 80 per cent against the USD, while the stock exchange index had dropped by some 50 per cent.

The steep depreciation of the *rupiah*, which was much steeper than those of the other affected Southeast Asian countries, set in train a chain of events which by early 1998 almost brought the country to near economic collapse. Unlike Thailand and South Korea which had also turned to the IMF for financial assistance and in return for this aid had from the outset implemented vigorously the agreed-upon reform programs, the Indonesian government did not seem fully committed to implement the reform program. Hence, when the *rupiah* failed to strengthen and the economy continued its downward slide, the Indonesian government in January 1998 was forced to sign a second agreement with the IMF which contained a more stringent and detailed 50-point reform program, covering monetary policy, fiscal policy, banking reforms, state enterprises reforms, structural reforms, and provisions on a social safety net for the economically vulnerable groups in society which had been the worst affected by the protracted economic crisis. (IMF II, 1998).

Even after having signed the second IMF agreement, the Indonesian government, specifically President Soeharto, still seemed reluctant to implement the agreement faithfully, particularly the structural reforms which were aimed at removing various policy-generated barriers to domestic competition and trade, such as eliminating the notorious clove monopoly managed by the youngest son of the President and the import monopolies of *Bulog*, the State Logistics Agency, on rice, wheat, flour, soybeans, and garlic. Many critics attributed the President's reluctance to implement the structural reforms to his unwillingness to harm the business interests of his children. Instead of going ahead with implementing the second IMF package faithfully, the President seemed to backtrack on his earlier commitment to implement the reform program, as reflected by his criticism that some of the IMF-mandated measures were 'unconstitutional'. It was at this time that the President lost his confidence in his economic technocrats and increasingly started perceiving the IMF-mandated reforms as containing a 'hidden agenda' which was aimed at eroding the financial foundations of his childrens' businesses, and his political power

rather than strengthening the rupiah.

To stabilise and strengthen the rupiah, the President in February 1998 seriously considered to introduce a Currency Board System (CBS), a concept which Professor Steve Hanke, a prominent originator of this system, tried to sell to the President. Under a CBS the currency board is the monetary institution which issues notes and coins which are fully backed by a foreign 'reserve' currency and fully convertible into the reserve currency at a fixed rate and on demand. The reserve currency is a convertible foreign currency chosen for its expected stability. A currency board must by law hold foreign exchange reserves which are equal to 100 per cent or slightly more of the notes and coins in circulation. (Hanke & Schuler 1994: 3). In the case of Indonesia the idea was to peg the rupiah to the US dollar by guaranteeing that the rupiah in circulation would be fully backed by Indonesia's foreign exchange reserves. The President tried to mollify the IMF by arguing that he was still committed to the IMF package, but since it had failed to stabilise and strengthen the rupiah, the need arose for an 'IMF plus' package, the 'plus' apparently referring to the introduction of a CBS.

Many Indonesian economists criticised the idea of introducing a CBS in Indonesia so precipitously, as foreign exchange reserves had dropped to a little more than US dollar 16 billion, which was considered to be too small to make a CBS credible. Moreover, the critics were concerned that under a CBS it would be the President's relatives and business cronies who might have preferential access to the precious foreign exchange which they could obtain at the relatively favourable pegged exchange rate, certainly more favourable than the prevailing exchange rate.

It is doubtful that the President was fully aware of the intricacies and implications of introducing a CBS, as his only concern was to stabilise the rupiah by pegging it to the USD. It was only after the urgent appeals of the heads of government of several donor countries and the diplomatic but clear warning of the IMF that it would withhold further financial assistance if Indonesia would go ahead with a CBS, that the President abandoned the idea of introducing a CBS.

However, precious time had elapsed because of the protracted debate about the CBS. As the rupiah failed to strengthen and economic conditions continued to deteriorate, the Indonesian government seemed finally ready to implement the reform package more seriously. On its part, the IMF too showed greater flexibility and understanding of the worsening economic conditions by agreeing that large food subsidies for the low income groups in society was inevitable. Hence, a third agreement was signed with the IMF in early April 1998 which allowed for a budget deficit of

around 3.5 per cent of GDP, instead of the 1 per cent of GDP agreed upon under IMF II. (IMF III, 1998). As the Indonesian government this time was perceived to be more seriously committed to implementing the terms of this third agreement, the *rupiah* gradually strengthened at a rate of Rp. 7,500 to Rp. 8,000 to the US dollar.

In May 1998, however, large student demonstrations against the government, sparked by the steep reduction in fuel subsidies, came to a head when four students were killed by unknown snipers, believed to belong to rogue elements of the army. In the aftermath of large-scale riots, arson and mass looting which broke out all over Jakarta and some other towns, notably Surakarta in Central Java, President Soeharto, under threat of impeachment by the no longer compliant leaders of the Parliament on May 21, 1998 resigned, after 14 of ministers in charge of various economic affairs refused to join a new, reorganised cabinet. Ultimately, however, the fall of Soeharto was due to his inability to reverse the economic collapse of the country.

In June 1998, a fourth agreement with the IMF was signed which took account of the further deterioration of the economy after the third agreement had been signed in April 1998, including the reduced fiscal capacity of the Indonesian government which made a larger budget deficit than the one agreed upon in the third agreement with the IMF inevitable. As a result, an agreement was reached that the government budget deficit would be allowed to expand to 8.5 per cent of GDP, of which 56 per cent (4.5 per cent of GDP) was to be financed from the committed external funds, while the remainder (44 per cent of the estimated budget deficit) would have to come from multilateral and bilateral aid. (World Bank 1998: 2.10). This additional budget support was provided by the Consultative Group on Indonesia (CGI), the aid consortium to Indonesia, which in its annual meeting in Paris in early July 1998 pledged a very large aid package amounting to US\$ 13.5 billion, a large part of which was to be spent on budget support, including loans to help financing part of the routine expenditures.

Hence, within a time span of only one year Indonesia had turned from a 'booming economy', extolled by the international aid community and many foreign economists as a development model worthy of emulation by other developing countries, into a 'melted down economy' dependent for its very survival on the charity of the international aid community and donor countries, including humanitarian aid provided by foreign NGOs (nongovernmental organisations).

To understand why and how Indonesia got into this unexpected economic predicament, the causes of the financial crisis will be outlined in the next section.

2. Origins of the Indonesian financial crisis

Despite the cautiously upbeat assessment of the 1997 World Bank Report on Indonesia's medium-term economic outlook, it did warn of a number of significant domestic and external risks which were at that time facing the Indonesian economy. These risks included persistently high core inflation, a weak banking sector, a rising exposure to the property sector, a slowdown in non-oil exports, a widening current account deficit, and a rapidly rising private external debt. (World Bank 1997: xxi). The Report also warned, prophetically, that adverse developments in the other Southeast Asian economies could spill over into Indonesia, and lead to a reversal of capital inflows. These risks were magnified by Indonesia's large external debt and the increasing sensitivity of global capital flows to changes in the above indicators. (World Bank 1997: xxi).

The events since July 1997 bear out that the above risks did in fact materialise in Indonesia as a sudden loss of investors' confidence, triggered by the depreciation of the Thai and Malaysian currencies, led to a reassessment of the risks involved in investing in or lending to Indonesian companies. In turn, this risk reassessment led to a considerable capital outflow and a concomitant depreciation of the *rupiah*.

Since the early 1990s foreign investors and creditors, buoyed by the prospects of the booming Southeast Asian economies, including Indonesia, and encouraged by the favourable assessments by the World Bank, the IMF, and reputable credit-rating agencies, such as Moody's and Standard's and Poor's, had recklessly provided huge loans to these economies for investments in the tradable and even more in the non-tradable sectors, particularly in property. In providing these loans these foreign creditors were conveniently overlooking the systemic flaws in the financial systems and distortions and inefficiencies in these economies. On its part, the Indonesian government too had ignored the above early warning signals, partly because it had little, if at all, information on the actual magnitudes of the capital in- and outflows, particularly the short-term capital inflows, and partly because it was still flush with euphoria about the booming economy.

The currency crises which hit the Southeast Asian countries, including Indonesia, since mid 1997 were triggered by international speculators who had been targeting the currencies of these countries for two main reasons. The first reason was their perception that the exchange rates of the Southeast Asian countries which had been linked to the US dollar since the mid 1980s could no longer be maintained. From the time these currencies, including the *rupiah*, were linked to the US dollar, large amounts of capital at low interest rates, much of it short

term and unhedged, had flooded into these countries, including Indonesia, without considerable foreign exchange risk. (Komine 1998: 2).

Although Indonesia, unlike Thailand, had not pegged its *rupiah* exchange rate to the US dollar, it did maintain, through its managed float, a quasi-fixed exchange rate tied with the US dollar and which was implicitly guaranteed by the government that the rate would remain closely pegged to it. (Hill 2000: 125-6). With domestic nominal interest rates about three times higher than those prevailing abroad and an open capital account (introduced in 1972), it was not surprising that Indonesian companies were encouraged to borrow large amounts of funds from foreign creditors, much of it short-term and unhedged (Hill 2000: 126).

Since 1996, however, this mechanism began to unravel as the inflation differentials between the Southeast Asian countries and the U.S. began to widen and the Japanese yen began to depreciate vis-a-vis the US dollar. As a result, the real effective exchange rates of the Southeast Asian currencies, including the *rupiah*, began to appreciate, thus resulting in reduced export competitiveness and contributing to rising current account deficits. (Komine 1998: 3).

The second reason accounting for the crisis was the burst of the 'bubble economy' which had been building up in the Southeast Asian countries, particularly in Indonesia, Malaysia, and Thailand, during the period 1994-1996. The 'bubble economy' had, like in Japan in the late 1980s and early 1990s, manifested itself in the form of a steep rise in the value of assets, particularly in regard to land and stock prices, to levels which bore little relationship to the real sector. The steep rise in the value of the assets was made possible by the vast loans provided by foreign institutional investors and foreign banks. (Komine 1998: 3-4). While the 'bubble economy' was building up, the value of both the assets and debts of the local debtor companies were rising neck and neck. However, once the 'bubble' had burst after the reassessment of the risks involved, the value of assets tumbled but not that of the debts. This burst of the 'bubble economy' was reflected in the deteriorating balance sheets of the debtor companies. (Komine 1998: 4).

Since the early 1990s Indonesia's private sector had gone on a borrowing spree, which caused Indonesia's total external debt (public plus private debt) to jump from around US dollar 70 billion in 1990 to around US\$ 140 billion in mid 1997 (which was more than twice as large as Indonesia's total exports). Of this amount, about one half was private debt, much of it short-term (with an average maturity of only 1.5 years). Moreover, much of the private sector's external debt was explicitly or implicitly guaranteed by the Indonesian government, as part of these foreign

loans were being used to finance large-scale infrastructure projects, to be undertaken by politically well-connected groups. (Vichyanond 1998: 19).

The involvement of Indonesia's private sector in infrastructure development started in 1993 when infrastructure development (including electric power generation) was opened to private investors, both domestic and foreign. With relatively limited funds at their disposal, Indonesia's private investors were looking for relatively cheap overseas sources of finance to fund these large-scale projects. However, involvement in these infrastructure projects was not only limited to private investors, as the Indonesian government was also involved in several of these projects through equity participation by state-owned enterprises (SOEs), long-term procurement contracts, or joint operation of these projects with revenue sharing. (Simanjuntak 1998: 3).

The 'bubble' first burst in Thailand, but then spread to Malaysia, the Philippines, and finally Indonesia. Initially the *rupiah* depreciation was indeed caused by the contagion effect from Thailand, as foreign investors and creditors undertook a wide-ranging reassessment of largely similar risk exposures in the other Southeast Asian countries, including Indonesia. The sudden concern of these foreign investors and creditors was in particular focused on the large, unhedged, short-term, off-shore loans which many Indonesian firms and their bankers had taken during the past year. The newly perceived risk was that these firms would be suffering big losses if the *rupiah* would, like the *baht* and the *ringgit*, also depreciate. It was feared that this, in turn, could very likely lead to a proliferation of bad debts among the Indonesian banks, some of which were known to be very weak. (McLeod 1997b: 42-43).

As concern about this new risk exposure turned into panic, domestic and foreign investors alike started selling their shares in listed companies, especially those considered vulnerable to foreign exchange risk, in order to reduce their own risk exposure. Subsequently, these investors attempted to convert the *rupiah* proceeds from these sales into US dollars (USD) or other strong foreign currencies. (McLeod 1997b: 43). As pressure on the *rupiah* increased, the *rupiah* began to depreciate against the upper boundary of the intervention band. Although the intervention band was widened further, pressure on the *rupiah* continued unabated. Having witnessed the costly and ultimately unsuccessful attempt of the Bank of Thailand to maintain the fixed exchange rate with the US dollar, the Bank of Indonesia on August 14, 1997, floated the *rupiah*.

The move to a floating exchange rate, however, only confirmed the worst fears of both investors and the wider public that what had happened in Thailand and the other Southeast Asian countries

could also happen in Indonesia (McLeod 1997b: 43). As people attempted to get rid of their *rupiah* holdings as fast as they could and convert them into US dollars or other strong foreign currencies, the free-floating *rupiah* depreciated even further, thus further confirming the worst fears about the inexorable downward trend of the *rupiah*.

Despite concern about these developments, the initial response of Indonesia's economic policy-makers was not panicky as they steadfastly held that the country's 'economic fundamentals' (low rate of inflation, a balanced budget, a rising but still manageable current account deficit, and adequate foreign exchange reserves) of the country were still basically sound. To stem the depreciation of the *rupiah*, the Indonesian government tightened monetary policy by raising the interest rates sky-high. This measure, however, further weakened the weak banking system even more, and encouraged further capital flight. (Montes & Abdulsalamov 1998: 180).

As the various government measures to stem the downward slide of the *rupiah* turned out to be unsuccessful, some prominent Indonesian economists pointed to the non-economic factors affecting the steep depreciation of the currency. For instance, in a widely published warning aired in early 1998 the late Professor Sumitro Djojohadikusumo, the *doyen* of Indonesian economists and former cabinet minister, attributed this loss of public confidence to a series of what he called institutional diseases, such as extensive corruption, collusion between government officials and businessmen, government-sanctioned monopolies, legal uncertainty, and a weak judicial system. Sumitro warned that getting out of this crisis would require immediate and firm action by the Indonesian government, specifically by attacking these institutional diseases in a more focused manner, despite the anticipated strong resistance from groups with vested interests in hampering the implementation of these reforms. (Djojohadikusumo, 1998). Other critical Indonesian economists also drew attention to other basic factors, particularly a wide range of policy-induced micro-economic distortions, such as various regulations and restrictions on domestic competition and trade which only benefited politically well-connected rent-seekers and over time had adversely affected the efficiency and resilience of the Indonesian economy to weather external shocks successfully.

Moreover, the extensive financial deregulation program which the Indonesian government had introduced in October 1988 had led to the establishment of a large number of private banks. However, this liberalisation program had not been accompanied by the introduction of a credible and adequate prudential protection of the vastly expanded banking system (Montes & Abdulsalamov, 1998: 180). Insolvent banks, controlled by the President's relatives and cronies, were allowed to continue operating. It was only after

the Indonesian government in early November 1997 had liquidated 16 insolvent banks under the IMF I agreement that a first step was taken to tackle the difficult problems of banking reforms. However, more than four years since the establishment of the Indonesian Banking Restructuring Agency (IBRA) by the Indonesian government to restructure the banking sector, IBRA has only made slow progress in selling the assets it controls and in restructuring the banks because of considerable political pressures and the lack of cooperation of well-connected bank owners.

Clearly, the origins of Indonesia's financial and economic crisis were as much political as economic, and therefore more intractable than in the two other worst afflicted East Asian countries, namely South Korea and Thailand where the economic crisis led to the speedy ouster of a discredited government and the installation of a new, popularly elected government strongly committed to the economic reforms prescribed by the IMF. While in these two countries a confidence crisis led to a currency crisis and subsequently to a financial and economic crisis, a political and social crisis was averted because of the assumption of power of a more credible government fully committed to implementing wide-ranging economic reforms. (Bhanoji Rao 1998: 1401-02; 1407).

In Indonesia, however, a discredited government not fully committed to implementing economic reforms tried to hang on to power for too long. Like in Thailand and South Korea a similar confidence crisis led to a similar currency crisis and subsequently to a financial and economic crisis, but then, unlike the two former countries, escalated into a full-blown political and social crisis. (Bhanoji Rao 1998; 1406-07). Unlike in Thailand and South Korea, in Indonesia the assumption of power of a new government under President Habibie in May 1998 failed to restore political stability, as the new president was widely perceived to lack political legitimacy. Consequently, the protracted political and social crisis, involving violent inter-ethnic and inter-religious conflicts in various places all over the country, severely hampered efforts to restore the political and social stability so urgently needed for the economic recovery of the country.

The impact of the economic crisis

a. The economic impact

The severe financial crisis of 1997/98 had a devastating impact on the Indonesian economy as reflected by the fact that GDP in 1998 contracted by an unprecedented -13.7 per cent. This economic contraction was much worse than in 1963 when the Indonesian economy contracted by nearly -3.0 per cent. (World Bank

1998: 2.1). It should be pointed out, however, that the size of the Indonesian economy in the mid 1990s, amounting to US\$ 215 billion in 1997, was much bigger than it was in 1965 when GDP was only US\$ 3.6 billion. Moreover, because of rapid economic growth which far exceeded population growth during the past three decades, per capita GDP in 1997 amounted to US\$ 1,075 as compared to only US\$ 190 in 1965. (Hill 1996: 5; World Bank 1985: 178; World Bank 1999: 194).

Although the financial crisis had already hit Indonesia in August 1997, GDP in 1997 was still able to grow by 4.6 per cent, which was much lower than the 7.8 per cent growth forecast by the World Bank in May 1997. (World Bank 1997: 29). However, as all the sectors were still able to record a positive though slower growth, overall economic growth in 1997 was positive too. The full impact of the financial crisis on the economy was only felt in 1998, with construction, the financial sector and business services, trade, hotels, and restaurants, manufacturing, and transport and communications recording the sharpest declines. On the other hand, agricultural output remained roughly constant and even recorded a very slight increase.

In 1999, however, the severe economic contraction was reversed, as GDP again by a positive, though miniscule 0.8 per cent. This slight recovery was to a large extent driven by increased private household and government consumption, which were growing again at 1.6 per cent, respectively 8.4 per cent after negative growth in 1998. Gross capital investment, however, was still growing at a negative rate (Thee 2000: 427). In 2000 GDP grew at an even higher rate of 4.8 per cent, primarily due to strong growth of manufacturing, utilities, construction, trade, and transport and communications (Dick 2001: 15). However, this performance could not be sustained in 2001 due to a slackening off of consumption growth and lower exports due to slower growth in the U.S., the largest market for Indonesia's non-oil exports. As a result, GDP in 2001 grew by only 3.5 per cent. Prospects for a higher growth of GDP in 2002 appear dim at present, with GDP projected to grow by 4.0 per cent at most.

As strong economic recovery requires a resumption in the growth of domestic demand strongly supported by renewed capital investment (World Bank 2000: 1), the failure to encourage new capital investment, particularly foreign direct investment (FDI) is a serious obstacle to Indonesia's short run prospect to achieve speedy economic recovery.

In addition to the financial crisis, Indonesia since 1997 also suffered the worst drought of this century because of the El Nino effect. The El Nino drought of 1997/98 was not only severe, but occurred twice, in July-August 1997 and in March 1998. (World Bank 1998: 1.11). Because of this drought, the planting of rice

had to be postponed by 1-2 months, causing a delay in the next cropping season. The drought also forced the farmers to switch production from rice to maize and soyabean. As a result, total rice production in 1997 fell by 4 per cent, causing the agricultural sector in 1997 to grow by only 0.6 per cent. (Johnson 1998: 16-17).

The El Nino drought also made it very difficult to fight the devastating forest fires in Sumatra and East Kalimantan in late 1997 and early 1998 which had been caused by the burning of forests by the operators of large estates, transmigration contractors, timber concessionaires and, to a smaller extent, the local shifting cultivators. (World Bank 1998: 1.11). Besides the huge crop and timber losses, the smoke from the fires deterred foreign tourists from visiting Indonesia and other countries in the region, and also caused serious damage to the health and well-being of millions of people. (Johnson 1998: 17).

b. The social impact

The socio-economic effects of the Asian financial crisis in Indonesia were basically transmitted through two channels throughout the socio-economic system. The effects through the first channel were caused by the impact of capital outflows, the steep depreciation of the *rupiah*, and the contractionary effects of tight fiscal and monetary policies on GDP and the various constituent sectors. The sharp contraction of various sectors, much of it located in the urban areas, such as construction, financial services, and manufacturing, led to many lay-offs in these sectors. The effects through the second channel were caused by the changes in relative prices, as prices of tradable goods (including manufactured goods) rose significantly vis-a-vis the non-tradable goods and services as a result of the steep depreciation of the *rupiah*. Hence, inflation rose steeply in 1998. (Daimon & Thorbecke 1999: 2).

The effects through these two channels suggest that urban households were affected more severely than rural households because, first, the sectors hit hardest by the crisis were mostly located in the urban areas and therefore adversely affected urban employment; secondly, inflation adversely affected the net purchasers of foodstuffs (largely urban dwellers) because of the steep rise in food prices in 1998, while the net producers of food (the farmers) gained. (Daimon & Thorbecke 1999: 2-3). Hence, urban households in general suffered more than rural households, specifically the farm households who could grow their own food.

- Unemployment

As a result of the economic slowdown in 1997 and the subsequent severe economic contraction in 1998, large numbers of workers were laid off, particularly in the labour-intensive construction, manufacturing, and modern services sectors which are mostly located in the urban areas. Despite the fact that hundreds of thousands of workers were laid off, the open unemployment rate only increased slightly to around 6 per cent according to the Labour Force Survey (*Sakernas*) conducted by the Central Bureau of Statistics (CBS) in August 1998. (Cameron 1999: 15).

Assuming a 30 per cent contraction in most sectors of the formal economy, the ILO estimated that wage employment would be reduced by 5.4 million wage employees. Adding this figure to the number of educated wage seekers of 3.9 million, initial open unemployment was estimated to be 9.3 million. However, because many of these open unemployed could not afford to remain unemployed for too long, it was estimated that about one half of the workers laid off because of the crisis would be absorbed in the informal sector. Hence, total open unemployment by mid 1998 was estimated to number 6.7 million people or 7 per cent of Indonesia's labour force, compared to just under 5 per cent before the crisis. (ILO & UNDP 1998: 28).

Data from the National Socio-Economic Survey (SUSENAS), held by the CBS in February 1998, showed large shifts in the composition of employment between the rural and urban, and between the formal and informal sectors. For instance, employment in manufacturing fell by 13 per cent, finance by 7 per cent, and electricity by 27 per cent. However, as some sectors, such as finance, were only employing a relatively small part of the labour force, even a relatively large reduction in employment in these sectors only had a relatively slight impact on total unemployment. On the other hand, employment in agriculture expanded because the labour market and the social structures in this sector were sufficiently flexible to reabsorb the workers laid off in the formal sector activities. (Poppele, et.al. 1999: 20).

Since many laid-off workers were forced to find self-employment in the informal sector, both in the urban and rural areas, in order to ensure their livelihood, the impact of the crisis on the welfare of the laid-off workers could be more accurately estimated by looking at the changes in the real incomes which the laid-off workers experienced after they joined the informal sector rather than looking at the change in the open unemployment rate (Cameron 1999: 15). However, as the informal sector became crowded with the large number of displaced workers, the main outcome of this movement was likely to be less work and lower earnings for all the workers in the sizable informal sector. (Breman 1998: 2; ILO & UNDP 1998: 25-26).

- Absolute poverty

The severe contraction of the economy, the attendant loss of jobs in the formal sector and the subsequent movement to lower income activities in the informal sector, and the hyperinflation and attendant drop in purchasing power which had occurred since late 1997 led to a significant increase in the number of people below the official poverty line, both in the rural and urban areas. Hence, one of the proudest achievements of the Soeharto administration, namely the sharp reduction in absolute poverty during its 32-year rule, was reversed as a result of the severe economic crisis.

Although there are varying estimates on the impact of the crisis on the incidence of poverty, there is no doubt that absolute poverty had increased and that economic distress was widespread among a large number of economically vulnerable people. Initial preliminary estimates by Indonesia's Central Bureau of Statistics (CBS) in mid 1998 indicated a dramatic increase in the incidence of absolute poverty as a result of the economic crisis.

Whereas by 1996 11.3 per cent of the Indonesian population (or 22.5 million people) were living below the poverty line, by the end of June 1998 the percentage of people living in absolute poverty was estimated to have jumped to 39.1 per cent (79.4 million people).

Assuming that Indonesia's GDP would decline by 12 per cent, the World Bank in mid 1998 came up with a much less pessimistic estimate than the estimates of the CBS and the ILO. According to the World Bank's estimates the incidence of absolute poverty would increase from 10.1 per cent of the population (20.6 million people) in mid-1997 to about 14.1 per cent (about 29 million people) in 1999. In view of the large numbers of workers laid off in the construction and manufacturing sectors located in the urban areas, the World Bank estimated that the poverty level in the urban areas would rise from 3.8 per cent in 1997 to 8.3 per cent in 1999, while in the rural areas absolute poverty would increase from 13.7 per cent in 1997 to 17.6 per cent in 1999. (World Bank 1998: 3.1).

However, the World Bank also pointed out that the largest increase in the absolute number of poor people would be in the rural areas, particularly among agricultural households hit hard by the El Nino drought. As some of the regions hit hardest by the El Nino drought also happened to be among the poorest, including East Nusa Tenggara, East Timor, and Irian Jaya, the incidence of poverty in these regions could rise to a high of 42.7 per cent. (World Bank 1998: 3.2).

More recent studies confirm that the earlier less

pessimistic estimates of the World Bank that the impact of the crisis on poverty, while serious, was not as disastrous as suggested by the CBS's and ILO's earlier estimates. For instance, a comprehensive study on the social impacts of the crisis conducted by Poppele, Sumarto, and Pritchett for the World Bank found that while the economic crisis had adversely affected the life of many Indonesians, the social impact had been quite heterogeneous and less dramatic than earlier estimates had indicated. According to this study overall absolute poverty had increased from 11.0 per cent in 1997 to 13.8 per cent in 1998, while poverty in the urban areas would rise from 9.2 per cent in 1997 to 12.0 per cent in 1998 and in the rural areas from 12.4 per cent to 15.2 per cent. (Poppele, et.al., 1999: 13-14).

- Health and education

Another serious consequence of the increase in absolute poverty was the rapid increase in the number of people having less access to adequate food supplies as well as health and education services. In fact, if food security is defined as a situation in which all households have economic and physical access to adequate food for all the household members, and where these households are not at risk of losing this access, Indonesia in 1997/98 was facing one of the most serious food insecurity periods in its modern history as a result of the economic crisis, specifically the drop in purchasing power of the growing number of poor people. (Tabor, et.al. 1998: 2).

Findings of a social impact study on the crisis indicated that the problem of food availability was more severe in the urban areas and in the rural areas on Java and in Eastern Indonesia. In the urban areas the problem of food availability was largely caused by the sharply reduced purchasing power of urban dwellers due to higher food prices, particularly of rice. In Eastern Indonesia the problem of food availability was mainly caused by the El Nino drought of 1997. (Sumarto, et.al. 1999: 17- 18).

Another serious casualty of the economic crisis was the reduced access of the low income groups to the important education and health services. As many workers had been laid off and high inflation had reduced the real incomes of the low income groups, many people were not able to enjoy good medical care, particularly in view of the sharp increase in the prices of medicine. Moreover, as the prices of powdered milk had increased steeply, many parents were not able to buy milk for their infant children. This had obviously an adverse effect on the physical and mental development during a crucial period in their young lives.

Findings of the longitudinal Indonesian Family Life Survey (IFLS), sponsored by the United Nations Population Fund (UNFPA)

and held in late 1997 and late 1998, indicated that the proportion of adult persons using public health service centres (*Pusat Kesehatan Masyarakat, Puskesmas*) had declined significantly from 7.4 per cent in 1997 to 5.6 per cent in 1998. Instead of visiting the public health service centres, many adults switched towards private providers or traditional practitioners. Similarly, the visits of children to integrated health services (*Pos Pelayanan Terpadu, Posyandu*) had also decreased significantly from 56.8 per cent in late 1997 to 41.3 per cent in late 1998. For the youngest children (under three years of age) the drop in visits to the health services has meant that a much reduced number of small children were receiving the important vitamin A. Not surprisingly, the IFLS found that the health of the poorest respondents in late 1998 had deteriorated compared to late 1997. (Frankenberg, 1999: 18-28).

Many parents from the low-income groups were also forced to pull their children out of school, often with the purpose that these children could help their parents in supplementing their meagre earnings. Tentative government estimates showed that about 6 per cent of primary school students (about 1,650,000 students) and 13 per cent of junior secondary school students (about 1,100,000 students) had either dropped out or were at risk of dropping out, while an additional 400,000 primary school students were unlikely to continue their education onto junior secondary school. (World Bank 1998: 3.3).

Various studies on the impact of the crisis on education showed that the fall in enrollment rates in secondary schools was much larger than in the primary schools. In fact, findings of several surveys indicated that there had either been no decrease or even a slight increase in the enrollment rates in primary schools. However, it should be pointed out that even before the crisis many children from the lower income groups, after having completed primary education, did not enroll in the secondary schools. Hence, it was not surprising that as a result of the crisis there had been more drop-outs at the junior and higher secondary schools rather than at the primary schools. (Poppele, et.al., 1999: 29). In order to address the drop-out problem in secondary schools, the Indonesian government in July 1998 introduced a scholarship program for poor secondary school students together with block grants to primary and secondary schools in poor areas. (Cameron 1999: 15).

Hence, yet another achievement of the Soeharto government in the field of social development, specifically the considerable expansion of education at all levels, particularly at the primary and junior secondary levels, and the expansion of basic health facilities all over the country, was being rapidly eroded by the severe economic crisis.

c. Remedial steps

With substantial financial and technical assistance from the IMF, the World Bank, the Asian Development Bank (ADB), the United Nations Development (UNDP), and the Consultative Group on Indonesia (CGI), the Indonesian government took various measures to protect the poor from the worst effects of the crisis, notably by providing a Social Safety Net (SSN), creating short-term job opportunities through labour-intensive public works, and preserving the availability of the key social services. (World Bank 1998: 1). These measures, however, were short run emergency measures designed to alleviate the misery of the people, rather than to put the Indonesian economy on a sounder footing.

However, due to inadequate targeting and maladministration, quite a sizable amount of SSN funds intended to alleviate the plight of the poorest sections of the population were either misused, simply wasted or even corrupted. As a result, the World Bank in April 1999 temporarily suspended the disbursement of funds allocated for SSN programs pending an overall review of the administration of the SSN funds.

The severe financial and crisis which had affected all East Asian economies to a greater or lesser degree has forced economists and other social scientists to take a new and more critical look at the performance of the so-called 'East Asian Miracle' or 'high-performing East Asian economies' (HPAEs), particularly Indonesia which had been the hardest hit by the economic crisis.

Concluding remarks

Rapid economic change during the Soeharto era was closely associated with the re-integration of the Indonesian economy with the world economy since the late 1960s and which had been strengthened after the end of the oil boom era in the early 1980s. This reintegration with the world economy had led to a more open economy, which in turn enabled Indonesia to benefit greatly from the 'static' and 'dynamic' gains from trade as well as from the favourable spillover effects from foreign direct investment. This greater integration with the world or global economy was in line with the rapid pace of global economic integration which since the early 1990s had accelerated dramatically, as reflected by the rapid rise in the ratio of world trade to world GDP and the equally rapid rise in the ratio of total foreign direct investment (FDI) to world GDP. (World Bank 1997b: 295).

However, the dramatic events during 1997 and 1998 in Southeast Asia, including Indonesia, clearly showed that

'globalisation' is a double-edged sword for these countries. While opening up their economies had undoubtedly led to more rapid economic growth and poverty alleviation in these countries, the destabilising effects of volatile short-term capital and long-term portfolio capital movements (Arndt 1998: 76-78) provided ample reason in these afflicted countries to ponder whether the benefits of closer integration with the world economy did not outweigh its costs. Despite the fact that the 'economic fundamentals' of Indonesia in early 1997 were generally considered to be adequate, these conditions nevertheless did not shield Indonesia from the devastating effects of the currency crisis.

While the positive case for closer integration with the global economy still holds, as attested by the relatively good performance of the Indonesian economy during the period 1966-96, priority should not only be given to continue adhering to sound macro-economic and micro-economic policies, particularly competition policies, and human resource development, but also to appropriate, sustainable institutions.

One important lesson from the East Asian crisis of 1997/98 was that the crisis was not caused by bad economic policies, but by the fact that its institutions were not up to carrying the load when these economies went through a difficult transition period. Indonesia's great weakness, not sufficiently realised by the economists, was that it had too many weak institutions and one very strong and unsustainable institution. Indonesia's weak institutions were its weak and outmoded legal system, its inefficient and corrupt public service, and an underdeveloped democratic process. The one strong and unsustainable institution was President Soeharto. (de Tray 1999: 1).

The second lesson from the East Asian crisis was that globalisation requires institutions to change faster than they are able to change. (de Tray 1999: 2). In the case of developing countries, including Indonesia, their capacity to change their institutions might have been even harder to accomplish, as they were still grappling with the problem of building appropriate institutions.

Indonesia's laggardness in building the appropriate institutions, as reflected by a weakly supervised and undercapitalised banking system, domestic microeconomic policy-induced distortions, widespread corruption and unproductive rent-seeking activities, and the venality of the government bureaucracy, yielded corrosive effects which did not only undermine the foundations and resilience of a national economy to weather external shocks, but also undermined the body politic and public confidence which were essential for a society and economy to weather big economic shocks successfully. In other words, the important challenge of 'good governance', once dismissed

contempuously as irrelevant turned out to be a crucial factor for Indonesia's economic recovery and future growth.

During the period 1966-96 rapid economic growth, windfall profits from the oil boom years, and the development of its vast natural resources enabled the New Order government, through its Inpres programs and redistributive policies to poor regions and the vast expansion of transport and communications networks to link the geographically dispersed regions together, to lay strong foundations for a modern, unified state and an integrated national economy. However, as its power accumulated at the expense of societal forces, its strong authoritarian and undemocratic nature eventually led it to pursue self-serving policies, notably the exploitation of the resources of resource-rich regions for the benefit of the central government, which over time led to strong discontent and even separatist movements, thus undermining the foundations it had laid during the preceding years to build a strong, modern state and an integrated national economy (Dick, et.al., 2002).

Aside from this, the accumulation of political power at the centre also tended over time to generate micro-economic interventionist policies which eroded a competitive business environment and, instead, rewarded unproductive rent-seeking policies. These policies also gave rise to the emergence of large collusive partnerships between political powerholders and their business clientele, many of them ethnic Chinese, which ultimately proved to be politically and economically unsustainable, and threatened the still brittle social cohesion of the nation.

Preoccupation with rapid economic growth and greed also led to severe environmental degradation and the depletion of scarce, non-renewable resources, which not only raised the social costs of economic growth, but also endangered the sustainability of the development process.

In the end Indonesia's ability for economic recovery and the resumption of sustained rapid, but also equitable and environmentally sustainable economic growth will not only depend on its ability to stick to sound macro-economic and micro-economic policies, but also its ability to build strong institutions, which can establish and enforce the basic rules governing the activities of the government and the public at large.

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