BAD DEBT:
THE POLITICS OF FINANCIAL REFORM IN INDONESIA

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BAD DEBT: THE POLITICS OF FINANCIAL REFORM IN INDONESIA

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Indonesia's transition from authoritarianism to democracy is taking place amidst widespread poverty, unemployment and social dislocation which fosters political instability. There is a pressing need for robust and sustained economic growth to reduce these problems, ease the strain on the state budget and smooth the political transition. The country's financial difficulties threaten to hinder this growth, with a serious potential knock-on effect to large-scale violence.

This report examines the measures agreed by Indonesia and its external lenders to reduce the public debt that is central to and symptomatic of those financial difficulties. It attempts to explain in political and institutional terms why the implementation of these measures has often run into difficulty and suggests ways in which the process might be made more effective and transparent.[1]

The financial crisis that triggered the fall of the Soeharto regime in mid-1998[2] left the country with huge public debts, equal in size to its gross domestic product. This debt, totalling about U.S.$ 154 billion, exacts a major human cost by absorbing funds that could be used to foster growth and alleviate mass poverty[3]. Some economists fear that it could eventually prove unsustainable, forcing the government into a politically damaging default.

Indonesia and its creditors, notably the International Monetary Fund (IMF), have agreed on a number of policy measures for reducing the public debt to more manageable levels. Through a series of Letters of Intent since October 1997, Indonesia and the IMF have agreed on renegotiating debt repayment schedules, cutting subsidies, increasing tax revenues, selling government-owned commercial assets, and restructuring private debt to the state. Indonesia has also committed itself to structural reforms of its legal and banking systems in order to sustain economic recovery, bring back the private investment that has largely forsaken the country, and reduce the risk of another financial

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[1] This report is based on interviews and conversations with more than 40 serving and former officials of the Indonesian government, government advisers, legislators, foreign economic officials and diplomats, private-sector bankers, lawyers, accountants and anti-corruption activists. In many cases, these people spoke on condition that they not be identified in any form. In other cases, the name of the interviewee is identified in the footnotes to the report, as are media sources.

[2] Indonesia's GDP fell nearly 14 per cent in 1998, was flat in 1999 and rose 4.8 per cent in 2000. Source: press reports.

[3] The government estimates that 24 per cent of Indonesians lived in expenditure poverty in 1999, meaning they could not afford a pre-defined basket of daily goods, compared to 18 per cent in 1996. Different statistical assumptions produce a figure of 27 per cent for 1999. Source: "Poverty Reduction in Indonesia: Constructing a New Strategy"; World Bank, 2000.

crisis. But despite the consensus between Indonesia and the IMF on what needs to be done and significant progress in some areas, the domestic implementation of certain key elements of this financial reform agenda has not been pursued with the necessary consistency or commitment.

The IMF's frustration with the slow progress of financial reform has led it to suspend its loans to Indonesia four times since 1997. IMF loans were being withheld as this report was written. The World Bank warns that further policy slippage could contribute to a "crisis scenario" which would cause it to cease new lending. While there are signs that agreement could be close on some of Indonesia's current differences with the IMF, the experience of the last three years suggests that tensions could rapidly re-emerge.

The slow and halting progress of financial reform can be partly blamed on the difficulties that any government would face in the midst of a wrenching political transition and on the arguably over-optimistic expectations of external lenders like the IMF. Reform has also been distorted, however, by the fragmentation of Indonesian politics since Soeharto's fall, a malfunctioning legal system and a political culture in which patronage and corruption play a key role. The problem is not a shortage of policy options, but the government's inability or unwillingness to implement fully a policy agenda that it has already agreed with its external creditors.

For implementation to move forward, there will have to be progress on a range of wider issues, including the reduction of corruption in politics and the legal system; greater cohesion within the government and a less adversarial relationship between the government and parliament. Indonesia's external lenders can have little direct influence over these issues, and it is probably not realistic, at a time when Indonesia's government is under heavy political attack from domestic opponents, to expect rapid progress on the financial reform agenda. Nonetheless, even incremental progress on implementing the fundamental reform measures agreed between Indonesia and its external lenders, which are discussed in detail in this report, is better than none at all.

RECOMMENDATIONS:

To the IMF

Scale back the program outlined in the Letters of Intent by favouring broad targets over unduly specific commitments where there is a high risk of delay for reasons beyond the Indonesian government's control.

Make deadlines for corporate debt restructuring more flexible to allow more time for reviews that increase transparency.

To Bilateral Donors

Consider further rescheduling or easing of terms on Indonesia's debt should its financial position weaken for reasons beyond the government's control.

Help parliament to make informed decisions on financial reform by offering funding and expertise to improve parliament's research capability.

To the Indonesian Government

Give highest political priority to reforming the legal system so as to reduce the impact of corruption on financial reform.

Avoid politically motivated targeting of tax and corruption investigations.

Enhance transparency by requiring that all transactions of the Indonesian Bank Restructuring Agency (IBRA) above an agreed size be reviewed independently, with the results made publicly available.

Consult systematically and routinely with all stakeholders in asset sales and privatisations, covering political and social as well as commercial issues.

Set recovery rates for asset sales that reflect market realities rather than politically derived assumptions.

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BAD DEBT:
THE POLITICS OF FINANCIAL REFORM IN INDONESIA

I. THE PUBLIC DEBT DEFINED

Indonesia's public debt stands at U.S.$ 154 billion, or around 100 per cent of gross domestic product (GDP).[4] The government hopes to reduce this to a more manageable 60 per cent of GDP within four years through measures discussed in this report. This goal could be attainable if the economy grows annually by more than five per cent during those four years,[5] but this will depend largely on the success of policies the government has agreed with the IMF.

The government owes roughly U.S.$ 74 billion to external creditors, notably the IMF, the World Bank, Asian Development Bank (ADB) and foreign governments, while state-owned companies have another $10 billion in foreign debts. The government owes another U.S.$ 70 billion within Indonesia, in the form of state bonds issued to bail out domestic banks. In addition to the debts of the state, Indonesian private companies separately owe an estimated $US 110 billion.[6]

The roots of Indonesia's debt problems lie in the New Order, the authoritarian regime of former president Soeharto, which ended with his resignation in mid-1998. During its 32-year life span, the New Order was increasingly characterised by endemic corruption and misuse of power by senior officials, their relatives and a charmed circle of business tycoons allied to the ruling elite.

The last decade of the New Order saw extensive deregulation of the financial sector and huge inflows of capital from foreign lenders and investors. This process was encouraged by multilateral organisations and governments from the industrialised world despite the frailty of Indonesia's banking and legal systems. The result was an economic boom and a borrowing spree by Indonesian conglomerates, often in violation of local banking laws and without proper risk assessment. Reckless borrowing was abetted by the ineffectiveness or corruption of state regulators and the poor quality of many commercial audits, including some carried out by international accounting firms.

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[4] The public debt, as of October 2000, broke down as follows: central government U.S.$ 134 billion, Bank Indonesia debt to IMF U.S.$ 10 billion; state-owned banks and companies U.S.$ 10 billion. Source: Bank Indonesia website www.bi.go.id. This debt is in the region of 100 per cent of GDP, though the exact ratio depends on what exchange rate and GDP assumptions are used. The value of the rupiah fluctuates so much that the U.S. dollar value of the public debt can vary quite widely. All figures in this report should therefore be taken as approximate, not exact.
[5] ICG interview with foreign economic official in Jakarta.
[6] Morgan Stanley Dean Witter research paper "Indonesia: a prime candidate for a permanent debt trap?" www.msdw.com.

When a sudden devaluation of the Indonesian currency turned the boom into a crash from mid-1997 onwards, many companies could no longer repay their large foreign-currency debts because of the fall of the rupiah against the U.S. dollar. Domestic interest rates rose and companies began to default on their debts. As defaults pushed banks into insolvency, the government had to choose between closing them and bailing them out. It chose to bail out most of the bigger and weaker banks, believing this to be cheaper and politically safer.

Unable to pay for bailouts in cash, the government issued bonds to the banks instead. In return, it acquired shares in the banks and took over their non-performing loans. This process, first mooted in late 1997, was not completed until October 2000. The government now holds loans with a face value as high as $30 billion and controls most of the bigger private banks. It is trying to recoup the cost of the bonds by reprivatising these banks, selling other assets acquired in the bailout and restructuring the loans so they can be sold back to the banks.

The risk that the government might default on its debts is relatively high by world standards, though smaller than in 1999[7]. Indonesian economists worry about the growing cost of debt service, which now accounts for half of the state's revenues and is expected to take up at least 30-40 per cent of revenues for several years to come.[8] The fear is that either the government will eventually have to default on some debt or that the cost of repayment will inflict unbearable damage on other areas of public spending.[9]

Indonesia's ability to reduce its debt burden depends partly on factors that influence economic growth but are largely or entirely beyond the government's control, such as the exchange rate of the rupiah and the world price of oil. Debt reduction also depends on the government's efforts to cut subsidies, sell nationalised assets and increase tax revenues.[10] The more successful these efforts are, the less the burden on the budget and the smaller the risk that Indonesia will be unable to meet its debts for the first time since the late 1960s. The government believes that a default would antagonise Indonesia's official creditors and further damage its image among private investors. It has therefore rejected a moratorium on debt repayment proposed by the parliament (DPR).[11]

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[7] Standard & Poor's, the ratings agency, rates the risk of default on Indonesia's long-term foreign debts at B-. This is higher than the CCC-plus rating that held for much of 1998 and 1999 and implied a significant risk of default. However, S&P and another influential ratings agency, Moodys Investors Service, both signalled in early March 2001 that Indonesia's financial outlook is worsening. Source: www.standardandpoors.com; www.moodys.com.
[8] World Bank, "Indonesia: Managing Government Debt and its Risks", May 2000; U.S. Embassy, Jakarta.
[9] This fear was expressed to ICG by, among others, Bank Indonesia's Senior Deputy Governor Anwar Nasution; former government adviser Sri Mulyani Indrawati and the head of the Danareksa Research Institute, Raden Pardede.
[10] The government plans to ease the repayment of domestic debt by issuing treasury bills to replace recapitalisation bonds as they mature. This will stretch out the repayment period while adding to the total interest that has to be paid.
[11] ICG interview with legislator Faisal Baasir of the DPR's Commission Nine on financial affairs.

Whether or not the debt is financially sustainable, however, it imposes a huge cost in human terms by absorbing public funds that could be used for more positive purposes. The 2001 budget sets aside 52 per cent of total state spending for debt service, compared to less than 7 per cent for health and education combined.[12]

II. EXTERNAL PUBLIC DEBT

The external debt of Indonesia's government, currently U.S.$ 74 billion, has grown from U.S.$ 53 billion since March 1997, on the eve of the financial crisis.[13] New debt is mostly in the form of emergency loans from multilateral lenders and governments, who pledged U.S.$ 43 billion at the start of the crisis and have made new pledges or rolled over their existing ones since then. (Indonesia did not in fact use all the pledged funds.) Commercial lenders are now reluctant to lend to Indonesia, though the government has considered various schemes for borrowing privately by using third-party guarantees. These schemes could in fact create new frictions between Indonesia and its multilateral lenders.[14]

This reliance on foreign official lenders is not new. In the late 1960s, when the New Order was establishing itself, external grants and loans accounted for nearly a third of state revenues. The support of Western countries and Japan for Soeharto's regime reflected its anti-Communism during the Cold War and Indonesia's importance as a source of cheap labour and raw materials and, increasingly, a market, as well as its strategic location on shipping routes.

Lenders commonly turned a blind eye to the gross human rights abuses of the Soeharto regime, notably the mass murder of Indonesian Communists in 1965-66 and the occupation of East Timor after 1975, and showed de-facto tolerance of its pervasive corruption. They now face the consequences in the form of resistance to reform by corrupt vested interests that became embedded in the state during the New Order.

The basic position that external lenders hold with varying degrees of emphasis is that Indonesia is too important to abandon and should therefore receive some foreign financial support. There is also a general feeling that the government is not doing enough to push reforms and reduce corruption. The trend is now to scale back lending, in agreement with the government, while offering a greater proportion of it on concessional terms and targeted at specific goals like the alleviation of poverty.

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[12] Calculation based on figures from U.S. Embassy Jakarta. These figures are based on the 2001 draft budget.
[13] The 1997 figure is from the World Bank: "Managing Government Debt and its risks", May 2000.
[14] The latest plan is for Indonesia to issue bonds backed by the revenues from natural gas sales to Singapore, which has a much higher credit rating than Indonesia. The World Bank has raised legal objections to the plan, however.

A. The International Monetary Fund

The most influential external lender is the IMF, whose programmes are used as a criterion by other lenders and for rescheduling of Indonesian government debt through the Paris Club mechanism. The relationship with Indonesia has been volatile and often interrupted since the IMF signed its first Letter of Intent (LOI) with the Soeharto government in October 1997. It committed Indonesia to a wide range of economic reforms in exchange for emergency loans. Since then, the IMF has suspended lending four times because of dissatisfaction with the way Indonesia has implemented these commitments.[15]

The reform agenda laid out in the LOI reflects the current global orthodoxy of deregulation, open markets and privatisation, combined with an emphasis on improving governance in Indonesia's financial and legal systems. These aims have been fairly consistent since 1997, though the details are frequently revised. Indonesia has shown few signs of wanting to break with the IMF altogether but successive LOI have been implemented belatedly or not at all.

Some financial sector examples make this point. The first LOI in October 1997 envisaged that troubled banks would be recapitalised with bonds. This took three years. It also stated that all banks should raise their capital adequacy ratio, a measure of financial health, to 12 per cent by the end of 2001. This level proved unrealistic and has been reduced to 8 per cent. Another 1997 stipulation was that at least a fifth of shares in one state bank would be privatised by October 1998. The first such sale is not expected before October 2001.[16]

Reform often threatens the interests of domestic groups who gained from the corruption and favouritism of the Soeharto era and are now fighting to defend their privileges. The members of these groups include businesspeople, state officials and members of Indonesia's military, which is still politically powerful and relies on its business operations for funds.[17]

At the same time, the domestic constituency that shares the IMF worldview, mainly liberal economists, has lost much of the influence it had during the Soeharto era. This reflects a more explicit nationalism within the political elite and the selection of ministers with backgrounds in NGOs or opposition politics. The first Co-ordinating Minister of the Economy during the Abdurrahman presidency, Kwik Kian Gie, and the current incumbent Rizal Ramli, were both previously critics of the IMF.

Even where the government does have the will to implement IMF reforms, it no longer enjoys the unchallenged authority that Soeharto commanded. Plans to sell nationalised banks back to the private sector, for example, are delayed by objections from parliament, which has become much more assertive and questioning of the executive. These problems of implementation have combined to create an extremely negative impression of Indonesia among foreign investors

[15] The IMF held up its loans to Indonesia between March and July 1998, between August and October 1999 and April and June 2000. A U.S.$ 400 million loan tranche, originally due in January 2001, was still being withheld in mid-March.
[16] Letters of Intent are reproduced on the IMF's website, www.imf.org.
[17] See ICG Asia Report N° 9 *Indonesia: Keeping the Military under Control*, 5 September 2000.

that itself becomes a problem when the government needs to attract investment to meet commitments to the IMF, such as privatising state assets.

The IMF is criticised for some of its specific prescriptions, notably its insistence on the over hasty closure of sixteen insolvent banks in late 1997, which resulted in a run on other banks, and a highly ambitious approach to reform in general which arguably demands far more than any state in Indonesia's current position can deliver. The highly specific and conditional nature of IMF programmes and the assertive style of its diplomacy seem to reflect lack of confidence in Indonesia's will to reform. At the same time, the IMF is often seen by Indonesian officials as intrusive. Trade and Industry Minister Luhut Panjaitan has expressed this attitude with the comment: "the IMF should trust us to set our own target of economic reforms. It cannot dictate to us."[18]

The IMF is aware of these views and knows it is suspected of helping to bring down presidents Soeharto and Habibie by cutting off loans at key moments. It has become more discreet in statements and made some symbolic concessions to the government last year, for example handing supervision of agricultural policy to the World Bank, which has more expertise in this area. For its part, the government continues to work with the IMF, not attempting, for example, to impose Malaysian-style capital controls to protect the rupiah. Even so, tensions that characterised the relationship during earlier periods have re-emerged, not only because of problems with the LOI but also because of new issues since 1997, notably over the central bank (Bank Indonesia) and fiscal decentralisation.

In late 2000 the IMF once more suspended lending. The U.S.$ 400 million loan tranche due in January 2001 had not been paid by mid-March. The delay was prompted by several concerns, the biggest of which is that amendments by parliament may undermine the central bank's independence from the government, which a 1999 law established.[19]

Another concern is that decentralisation, which began this January, will prompt local governments to borrow money they are unable to repay, forcing the central government to bail them out. The government has put forward regulations to discourage such borrowing, but the IMF wants a stronger ban. The IMF also worries about delays in the sales of nationalised assets and a lack of transparency in the restructuring of some private debts to the state.

Negotiations between Indonesia and the IMF were continuing as of early March, and there were signs of progress on a major sticking point, the independence of Bank Indonesia. The two sides agreed to appoint a panel of four central bankers, two Indonesian and two foreign, to study the amendment of the central bank law. This followed several rounds of talks in Washington and a visit to Jakarta by four international figures invited by President Abdurrahman to advise him. They strongly advised Indonesia not to cut its ties with the IMF, and Abdurrahman later stated that his government would continue to work with the Fund.[20] It is not

[18] *Straits Times*, 21 February 2001.
[19] *Financial Times*, 8 February 2001.
[20] *Straits Times, Jakarta Post*, 26 February 2001. The four are Singapore's Senior Minister Lee Kuan Yew; Paul Volcker, former head of the U.S. Federal Reserve, Japanese ex-ambassador Nobuo Matsunaga, and German banker Ulrich Cartellieri.

clear, however, how close the two sides are to an agreement which would prompt the Fund to resume lending.

The IMF walks a fine line with Indonesia. It wants to avoid being seen as undermining the government by suspending loans. On the other, it has a global role and a responsibility to all its governmental shareholders and cannot be too lenient if Indonesia appears to stall on reform. Following heavy criticism and problems of implementation in countries like Indonesia, the IMF is now planning a new worldwide approach which would narrow down the range of conditions it demands in return for its loans and place more emphasis on broad principles, rather than setting detailed lists of reform targets.[21]

Applied to Indonesia, this streamlining of the LOI approach could smooth relations between the government and the IMF by reducing the number of potential flashpoints and placating Indonesian critics who complain that the LOI in its current form is too intrusive and detailed.

However, there are signs that the IMF and some of its major shareholders, notably the United States, have become increasingly frustrated with the slow progress of reform in Indonesia.[22] It seems likely, therefore, that the IMF will continue to withhold loans rather than compromise on issues which it considers central to its programme, even if the size of that programme is scaled back. There is also a risk, given the disarray of Indonesia's political system and the wide scope for vested interests to obstruct reform, that new problems could emerge to disrupt the relationship again even if current differences are resolved.

Although Indonesia is not in desperate need of IMF funds as such, delays in IMF lending can hold up loans from other creditors and stall the rescheduling of debt through the Paris Club, which would have serious implications for the budget. They also deter the private investment needed to sustain economic recovery.

B. The Development Banks

The World Bank and Asian Development Bank (ADB), by their nature, have a broader and deeper involvement with Indonesia than the IMF, and their ability to halt lending is more constricted. While the IMF has stopped lending four times to pressure Indonesia's government, the World Bank has only done so once in August 1999 and hinted that it might do so again in late 2000. [23]

The World Bank defends its role during the Soeharto era, but this is controversial in some quarters, notably among local NGOs who associate its loans with the endemic corruption. Press reports have revealed that as much as a third of the World Bank's loans to Indonesia during the New Order may have been embezzled by government officials.[24] The World Bank has since made efforts to curb abuses and consult more widely outside the government. The ADB may have lost a

[21] Dow Jones Newswires, 7 March 2001.
[22] ICG confidential interviews.
[23] Lending was stopped over the Habibie government's failure to clear up the Bank Bali scandal and its failure to stop violence by its troops and their proxies in East Timor ahead of a referendum on independence from Indonesia.
[24] *Wall Street Journal*, 15 July 1998 and 19 August 1998.

similar proportion of loans through corruption,[25] though it has a much lower public profile in Indonesia and has attracted less criticism. The ADB is also considering making loans to Asian governments partly conditional on their fighting corruption.[26]

Worried about the size of the public debt and the financial impact of administrative decentralisation, which began this year, the World Bank is scaling back its lending to Indonesia from more than U.S.$ 1 billion a year to U.S.$ 400 million. There is to be a proviso that up to U.S.$ 1 billion could be lent, however, if the government makes progress with financial reforms. This reduction has been agreed with the government and is softened by the offer of a third of the money in the form of concessionary loans.

Since adopting this new strategy, the World Bank has warned that there is a "significant possibility of a crisis scenario" if relations break down entirely between Indonesia and the IMF, there is widespread political instability or a collapse of law and order. If this happens, the World Bank says it will cease new lending while continuing existing projects. It has hinted that if Indonesia needs another international financial rescue like that of 1997-98, it may find it difficult to provide much new money.[27]

This statement was issued when negotiations between the IMF and Indonesia had yet to show much progress and could be read as a warning to Indonesia of the consequences of backtracking on agreed reforms as well as a response to growing political uncertainty in the country. However, the World Bank says the crisis scenario is less likely than its "base case", in which there is some slippage on reform but the macroeconomic environment remains relatively stable.

C. The Consultative Group for Indonesia

Indonesia's official lenders and donors are grouped into the Consultative Group for Indonesia, a forum that meets once a year to discuss how much money will be pledged in loans and grants. The CGI itself does not make loans or grants, the terms of which are negotiated bilaterally by Indonesia and each lender or donor. Japan, the ADB and the World Bank pledge 90 per cent of CGI funds.

As Indonesia's economy has recovered and its public debt has grown, so the pledges by CGI members have fallen. At Tokyo in October 2000, members offered U.S.$ 4.77 billion in loans and U.S.$ 660 million in grants. Much was not new money but pledges extended from the previous year. In the 1998-99 financial year, by contrast, CGI members pledged U.S.$7.9 billion.[28] In practice, much of the money pledged by CGI members is not drawn on by Indonesia.

[25] ICG confidential interview.
[26] *Financial Times*, 12 February 2001.
[27] "World Bank Country Assistance Strategy for Indonesia", 8 February 2001.
[28] Source: press reports. IMF loans do not fall under the CGI for technical reasons.

The most influential bilateral lenders are the governments of Japan and the United States. Japanese investors account for by far the biggest share of foreign direct investment in Indonesia, and the Japanese government provides a third of all external loans to its government.[29] Japan has a major strategic interest in Indonesia, which lies across its shipping links to the Middle East and Europe, and it is worried about the possibility of Indonesia breaking up under separatist pressures. The Japanese government tends to put much less emphasis than the U.S. government on rapid economic reform, but it does appear to feel that reform could be faster. While it might argue at IMF board meetings for more tolerance of delay, the Japanese government does not want to see Indonesia abandon the IMF program altogether.

The U.S. government, represented directly through its officials and indirectly through its leading role in the IMF, has pushed forcefully for a variety of goals, including more rapid implementation of the IMF agenda and non-financial issues such as control of paramilitary groups in West Timor. U.S. officials have also argued against threats of legal action over Soeharto-era contracts signed by US companies. [30] This fairly overt pressure has had mixed results and appears to have been toned down in recent months following hostile criticism from some Indonesian politicians.

The U.S. Treasury is said to be frustrated by lack of progress on the reform agenda. The official U.S. statement at the October 2000 CGI meetings included, in its first paragraph, an explicit complaint at the delay in sales of two banks, Bank Central Asia and Bank Niaga. The IMF shares this frustration, though the DPR belatedly announced in February 2001 that the sales could go ahead.

D. External Debt as a Political Tool

Indonesia's economic weakness since 1997 and its legacy of cash-strapped governments have made it possible for external lenders to demand far more in policy commitments than would have been possible under Soeharto. But as the relationship with the IMF shows, Indonesian governments often commit to far more than they are willing or able to carry out.

Aside from the goals of restructuring Indonesia's economy and encouraging its democratisation, external lenders have sometimes tried since the fall of Soeharto to exert pressure on specific political issues. This can be effective when lenders share the same goal, particularly if there is a constituency within Indonesia which also shares that goal. The suspension of lending in 1999 over mass violence in East Timor and the Bank Bali scandal served the purposes of opponents of then-president Habibie, who stepped down soon afterwards.

[29] Indonesia approved about U.S.$ 36 billion worth of Japanese non-oil investment between 1967 and 2000. U.S. companies were in sixth place in terms of non-oil investment approvals, with a cumulative value of U.S.$ 10.5 billion, but first in oil and gas. Not all the approved investments actually took place. Source: www.usembassyjakarta.org.

[30] This threat was raised by the Indonesian side during contract disputes involving the Indonesian state electricity company, U.S. private power firms and a U.S. state agency, the Overseas Private Investment Corporation, but Indonesia has agreed to resolve all such disputes through commercial negotiations.

But although the Indonesian government and the DPR are still committed to the reforms advocated by lenders, the political mood shifted during the second half of 2000 towards a more assertive nationalism. Politicians increasingly object to what they see as "foreign interference". This creates a risk that if external lenders push too hard on any particular issue, they may trigger a backlash within Indonesia which undermines their wider aims.

Despite the limitations of external debt as a tool for specific policy goals, debt negotiations can be used to signal lender priorities. Recent CGI meetings have taken a strong stance against illegal logging of Indonesia's rainforests, for example. How far the government can meet such concerns is a separate issue.

E. Indonesian Attitudes to External Debt

Many Indonesians, including officials, legislators and NGOs, are uncomfortable about their country's dependence on external debt. "We need the debt, but we think it's not necessary. It's an internal dilemma," comments Frans Seda, a veteran former minister.[31] As a result, debate tends to be narrowly focussed on debt reduction. A foreign economic official in Jakarta laments that "People don't ask: when should we borrow, on what terms and for what purpose? They only say: how can we have less debt?"[32]

This view is motivated by the cost of the public debt and dislike of the intrusive role played by external creditors, notably the IMF. As noted, this dislike goes hand in hand with the growth in nationalist rhetoric in Indonesian politics since mid-2000. Economic nationalism is nothing new in Indonesia but it has become more overt, partly in response to international pressure for more rapid action on economic restructuring. This sentiment does not stop Indonesia from planning to borrow from commercial sources, for example by selling bonds backed by revenues from natural resources like gas. Such borrowing might cost more than official loans but would come without onerous policy conditions.

Another motive, particularly strong among NGOs, is an association between debt-funded development spending and corruption during the Soeharto era. A statement to the CGI meetings in October 2000 by the International NGO Forum on Indonesian Development (INFID), called on CGI members to cancel "odious debt" and prosecute those responsible for embezzling foreign loans in the past.[33] This is not supported by the government but has been used by DPR members to argue that Indonesia's creditors should allow a debt moratorium.[34]

Despite the controversy, there seems little chance at the moment that the government would willingly decide to default on its loans. Indonesia has more than 30 years' experience of managing its foreign debts without having defaulted and has preferred in the past to cut other spending rather than miss repayments. Nonetheless, both government and creditors are keen that the debt be reduced.

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[31] ICG interview with Seda.
[32] ICG confidential interview.
[33] INFID statement to the CGI, 11 October 2000. The term "odious debt" refer to debt which, NGOs argue, the Soeharto regime lacked the legitimacy to contract. The "criminal debt" argument, usually directed at the World Bank, is that money was lent even though lenders knew it might be embezzled. The force of these arguments is moral rather than legal.
[34] Reuters, 27 February 2001.

III. REDUCING EXTERNAL DEBT

In the last two years, Indonesia has rescheduled U.S.$ 10 billion of foreign bilateral debt through the Paris Club, an informal grouping of creditor governments, spreading out repayments for up to 20 years. Indonesia has reportedly agreed not to ask for any more Paris Club rescheduling, though another U.S.$ 340 million of commercial debt to foreign private banks was rescheduled along similar lines through the London Club in September 2000.

Indonesia is not considered poor enough to meet international criteria for outright debt forgiveness, and some lenders, including the World Bank and the Japanese government, object in principle to writing off debt. The current stance of lenders seems to be that Indonesia still has scope to raise money by measures such as cutting subsidies, increasing tax revenues and privatising state-owned companies rather than asking for debt relief. Nonetheless, the increasing willingness to provide loans on concessionary terms is a sign that lenders recognise Indonesia's financial difficulties.

A. Cutting Subsidies

Indonesia plans to save money by cutting fuel subsidies, which will account for at least 12 per cent of public spending this year.[35] The economic arguments over these subsidies are beyond the scope of this report, but the usual criticism is that they disproportionately benefit the wealthy minority who own cars, while also encouraging fuel smuggling. The Abdurrahman government first planned to cut subsidies in April 2000, but delayed for fear of mass protests. In the event, there were no significant protests when the cuts went ahead in October.

The next test is in April 2001, when fuel subsidies are due to be cut a further 20 per cent. The official position at the end of February was that the cuts would proceed, but as protests intensified in Jakarta in mid-March against the Abdurrahman presidency, ministers announced that the extent of subsidy cuts would be scaled back so as not to directly affect the general public.[36] In short, subsidies will be cut, but the scale and timing may well be influenced by short-term political considerations even if this has a negative impact on the budget.

B. Increasing Tax Income

Indonesia's tax collection rates are very low by world standards. Last year, it collected tax revenues equal to 11.1 per cent of GDP, and this year's budget has set a target of 12.3 per cent. This is far lower than the Southeast Asian average.[37] There are only about half a million registered taxpayers in a country with more than 200 million people, and tax registration among companies is equally low.[38] The major obstacles to increased collection of tax are lobbying by vested interests and rampant corruption among tax officials. A recent academic

[35] US Embassy figures.
[36] Source: www.detik.com, 12 March 2001.
[37] In 1997, Indonesia's tax to GDP ratio was 10 per cent. The Philippines' was 16 per cent and Malaysia's 37 per cent.
[38] *Straits Times*, 13 November 2000.

study also found that taxpayers regarded tax officials as "arrogant" and were baffled by complex tax rules.[39]

The amendment of policy after it has been announced, in public and under pressure from interest groups, is a general feature of financial policymaking in Indonesia that is particularly marked in the case of taxation.[40] It implies either that the original policies have not been researched properly or they are correct but the government is unable to face down the opposition they generate. The former Director-General of Taxation, Machfud Siddik, told the local media before being replaced in February 2001 that he was facing pressure not only from influential taxpayers but from officials within his own department. His replacement has been attributed in press reports to refusal to mount politically-motivated tax investigations against opponents of the government. [41]

Perhaps the greatest obstacle to increased collection of tax is corruption within the tax directorate. It is an open secret that tax inspectors often collude with taxpayers, with the former receiving a kickback in return for reducing the amounts the latter pay. Siddik said in mid-2000 that tax officials with salaries in the low millions of rupiah are easily tempted when dealing with companies that owe billions of rupiah in tax.[42] As a result, it is difficult to assess how successful the government will be in raising tax revenues over the long term without a cleanup of tax administration.

C. Privatisation

The aim of privatisation since 1998 has not only been to raise funds for the budget but also to rid the public sector of companies which are often loss-making, badly run and havens of corruption and patronage.[43] The program had little success under the Habibie government and has had none under the Abdurrahman government, which raised no revenue from privatisation last year. The minister in charge of state-owned companies under Habibie, Tanri Abeng, comments that "politics has derailed the privatisation program completely and today it is a total failure."[44] The reasons for this include opposition by public-sector managers, Indonesia's poor image among investors and frequent (and possibly politically motivated) reshuffles of officials in charge of the programme.

A problem with all asset sales in Indonesia is that a transaction may be challenged by objectors after it has been concluded. A stake in Semen Gresik, a state-owned cement firm, was sold to the Mexican company Cemex during the Habibie administration. Because of local complaints, two of its plants are now to

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[39] *Bisnis Indonesia*, 26 February 2001. The survey did not mention corruption, which may fall under "arrogance."
[40] Plans to impose value-added taxes on the industrial zone of Batam island, for example, were a commitment in the latest LOI in September 2000 but these plans were postponed after protests from businesses there. Far from paying more tax, Batam is now set to become a tax-free zone.
[41] *Indonesian Observer*, 5 December 2000; *Detak* magazine, 14-20 February 2001.
[42] Unpublished interview with the author of this report.
[43] Privatisation in Indonesia means the sale of public-sector companies, not private companies that have been taken over by the Indonesian Bank Restructuring Agency.
[44] *Straits Times*, 19 January 2001.

be spun off as separate companies in which Cemex may have no role.[45] Such cases imply a lack of legal certainty that could well deter potential investors.

There is a lack of consistency in the way the privatisation portfolio is run. It was moved from the Finance Ministry by Habibie in 1998 and given its own ministry under Tanri Abeng, a businessman. Abdurrahman replaced Abeng with Laksamana Sukardi, a supporter of Vice-President Megawati Soekarnoputri with a reputation for integrity. Six months later Sukardi was replaced by Rozy Munir, a presidential loyalist. Four months after that, the ministry was dissolved and the portfolio given back to the Finance Ministry. The reason for these constant changes is not clear, though state-owned companies have traditionally been used in Indonesia as sources of money that can be diverted for political patronage.

Despite past failures, the DPR has required the government to raise the same amount this year as it failed to in 2000, while also asking state-owned companies to contribute a third more revenue to state coffers than last year. These targets seem optimistic, and it seems quite likely on the basis of experience that privatisation will not be a major source of revenue for some time.

IV. DOMESTIC DEBT

A. Bank Restructuring

Many private banks were used during the Soeharto era as cash cows by the conglomerates that owned them, often in violation of law and prudent banking practice. When the crisis forced the conglomerates to default on their loans from mid-1997 onwards, the biggest banks were pushed into insolvency. The state-owned banks were in even worse state after years of corruption, bad management and politically motivated lending.

The restructuring of the banking sector did not begin in earnest until early 1999. Proceeding in fits and starts, it has reduced the number of banks from 237 to 166 (including foreign banks) through closures and mergers. About 70 domestic banks, mostly small, remain fully in private hands. The rest are either public-sector banks or formerly private banks now controlled by the state, which plans to sell them back to the private sector.

The bailout was much more expensive than expected, because it took much longer than expected, and banks continued to lose money while they waited to be recapitalised. At the end of 1998, the cost was put at 253 trillion rupiah.[46] By July 2000, the government had issued bonds with a face value of 653 trillion rupiah, or more than U.S.$ 60 billion .[47] The World Bank has said the bailout "may prove to be the most expensive in history in terms of GDP." [48]

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[45] *Bisnis Indonesia*, 7 February 2000. It is not clear whether the objections stem from complaints by local people or the desire of local officials to control the cement plants and their revenues, or possibly both.
[46] *Financial Times*, 12 December 1998.
[47] Two-thirds of the bonds were issued to commercial banks and one-third to Bank Indonesia to cover its emergency loans to commercial banks. The rupiah figure does not include interest costs. Source; Bank Indonesia.
[48] World Bank, "Accelerating Recovery in Uncertain Times", October 2000.

The slowness of the process can be explained partly by its size and complexity. Indonesia had never faced banking problems on such a scale and had to fashion the laws and institutions to deal with the crisis as it went along. But bank restructuring has also been distorted by the attempts of interest groups to win control of funds or assets, either by legal manoeuvring or by lobbying politicians.

The most blatant example of political involvement is the case of Bank Bali, which hired lobbyists close to the Habibie administration in 1999 to speed up the long-delayed repayment of a debt owed to it by the state. The lobbyists retrieved the debt, took half as their fee, then passed some of the money to leading figures in the then-ruling Golkar party. The ensuing scandal implicated senior officials and led the IMF and the World Bank to cut off loans. Habibie fell from power soon afterwards. Although the Abdurrahman administration vowed to resolve it, the Bank Bali case has come to exemplify the failings of Indonesia's legal system. All key suspects have either been cleared or acquitted on appeal. The failure of the attorney-general to secure a single conviction has fuelled suspicions of corruption amongst prosecutors.[49]

B. The Outlook for Banks

Recapitalisation has reduced the immediate threat to Indonesia's banks by replacing most of their bad loans with state bonds.[50] Banks have tended to hold onto these bonds, which are low risk, rather than make new risky loans to the private sector. In cases where banks have tried to sell bonds to raise cash for lending, they have found few buyers because the bonds are less attractive than other government securities. Indonesia's banking industry is thus being protected by its inability or reluctance to make loans.

Even so, certain risks could force the government to carry out more rescues. One is that banks' existing borrowers might be pushed into default if there is a sharp fall in the exchange rate or if interest rates continue to rise. The central bank imposed technical measures in January 2001 that will make it harder for speculators to drive down the exchange rate. These had some temporary success, but the rupiah fell steeply again in March.

Rising domestic interest rates pose a variety of problems. Companies with rupiah debts will find it harder to repay, while some banks risk going into the red again. This is because they hold types of recapitalisation bonds which pay them fixed interest rates of 12 or 14 per cent, while the rates they have to pay to depositors are rising above this level. At the same time, other banks hold bonds that pay them a floating rate, meaning that they benefit from rising interest rates. A split is thus emerging between banks which risk being dragged back into the red and banks which are making windfall profits at the state's expense.[51]

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[49] ICG interview with staff at Indonesia Corruption Watch. In a separate case, Britain's Standard Chartered Bank tried to buy Bank Bali from the government but was driven off by a staff revolt.

[50] Recapitalisation raised the capital adequacy ratio, a measure of financial health, to at least 4 per cent for all banks. The international minimum is 8 per cent, and banks are supposed to reach this level by the end of 2001. Some are already well above it, but others may struggle to raise the extra capital, forcing them to either close or merge.

[51] See Dow Jones, 6 March 2001. The government and Bank Indonesia are caught in a cleft stick. If interest rates do not rise, the rupiah may fall further and indebted companies will be pushed towards default. If they do rise, some of Indonesia's biggest banks will be damaged.

There are other issues facing particular banks. The public-sector Bank Mandiri is known to be facing liquidity problems, while the government was forced in early 2001 to guarantee a U.S.$ 1.2 billion debt to the nationalised Bank Internasional Indonesia because of fears the debt might go into default. If there is a default, the government will have to take over the debt and try to acquire assets of equal value from the borrower, a troubled Indonesian conglomerate called Sinar Mas. Past experience suggests that this process would be lengthy and problematic. Other banks could face similar problems.[52]

These concerns should be seen in perspective. Indonesia is unlikely to suffer another banking crisis on the scale of 1997-99, if only because banks now hold fewer loans that can go bad. But uncertainty is likely to persist for some time, as is the risk that the government will have to carry out more bailouts.

If the financial health of the banking industry improves, another issue arises: whether banks have restructured their management and operations so as to reduce the risk of new debt problems. Some, unnerved by the crisis and worried by growing foreign competition, have reformed themselves internally. The depth and effectiveness of such changes, and the vigilance of central bank regulators is unlikely to be tested until the economy recovers more strongly, however, and banks are in a position to lend more extensively. It is probably premature to conclude that commercial banks as a group have decisively changed the way they manage themselves and are therefore less vulnerable to future crises.

As for the public-sector banks, one well-informed foreign source dismisses the internal restructuring in three of the four major banks as no more than "box-ticking", meaning changes of form rather than substance. There has been more progress at the fourth, Bank Mandiri, which was itself created from the merger of four failed state banks, though it is not clear how effective the changes have been.[53] Concerns are also likely to remain that state banks are being pushed to make loans for political purposes, though increased scrutiny by auditors, legislators, NGOs and the press will hopefully reduce the scope for this.

C. Bank Indonesia and Bank Supervision

The task of regulating banks falls to Bank Indonesia, the central bank, a task in which it failed dismally during the Soeharto era. Its role then as an "agent of development', providing subsidised loans, was also widely abused. Bank Indonesia, in the words of senior deputy governor Anwar Nasution, was used as "a cashier for Soeharto and the rulers." Nasution has resigned on principle over the misuse of central bank money although he was not at Bank Indonesia at the time, and he is waiting for a replacement to be appointed. Other members of the board have also resigned.[54]

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[52] *Business Times*, 6 February 2001.
[53] ICG confidential interview.
[54] ICG interview with Nasution. Some observers link these resignations to the government's attempts to remove Bank Indonesia's governor, though Nasution denies this in his own case.

The most egregious misuse of Bank Indonesia's powers was in the disbursement of loans to banks with cash flow problems in late 1997 and early 1998. These loans, known as BLBI in Indonesian, have given rise to a financial scandal that dwarfs all others in Indonesia. State auditors found that out of 144.5 trillion rupiah (currently U.S.$ 15 billion) in loans, more than 90 per cent could not be properly accounted for and over half had been misused.

The responsibility for catching the BLBI culprits lies with the attorney-general's office, which has made little progress and only belatedly announced in early 2001 that it was ready to investigate senior central bank officials. One well-informed source laments that given corruption in the courts and the lack of political will to solve the case, no one may ever be punished.[55]

The attorney-general, Marzuki Darusman, is bringing a case against Bank Indonesia's governor, Syahril Sabirin, in connection with the Bank Bali scandal, though this is often seen in Indonesia as an attempt to replace Sabirin with a government loyalist. Marzuki says his department's poor record reflects tactical errors by prosecutors. To critics such as Indonesia Corruption Watch, a respected NGO, it suggests that prosecutors have been bribed to do their job badly. ICW wants Marzuki to resign and has considered bringing a class action against his department.[56]

Bank Indonesia itself has taken little firm action to punish corrupt or incompetent officials. One senior official has been demoted over the BLBI scandal and several others transferred from banking supervision to other departments. Nasution says, however, that to his knowledge, no officials have been prosecuted or dismissed from the central bank.

Bank Indonesia was given its independence from government by a law passed by the Habibie government in 1999 which provides strong legal safeguards for its board of governors, including Sabirin, against dismissal for other than criminal acts. The current government says it was a mistake to give Bank Indonesia such protection without reforming it first. The amendment of the law by parliament has been bogged down in what is seen as the government's desire to get rid of Sabirin and the desire of some political parties to win influence over the central bank. These concerns are so serious that the IMF has made preservation of Bank Indonesia's independence a condition for resuming its loans.

Despite these distractions, Bank Indonesia has taken steps to improve its supervision of the banking system. It is bringing prudential regulations into line with international standards and now requires executives of private banks to pass a fit-and-proper test. It has placed staff in some private banks as monitors, though they may not themselves be skilled bankers, and regulation has swung from laxness to a conservative, by-the-book approach.[57]

These measures will only be tested in more bullish business conditions. The best-case scenario is that they will act as a check on the poor regulation, corruption and political influence of the past and thereby reduce the risk of a future banking crisis on the scale of 1997-98. But given the lack of effective legal checks on

[55] ICG confidential interview.
[56] ICG interviews with Marzuki and with staff at Indonesia Corruption Watch.
[57] ICG interview with Gunarni Soeworo, chairwoman of the National Banks Association.

official misconduct, it seems unlikely that such problems will be entirely eliminated in the foreseeable future.

D. The Indonesian Bank Restructuring Agency

Earlier sections have discussed how the financial crisis forced the government to bail out banks by recapitalising them with state bonds. The state agency charged with recouping the costs is the Indonesian Bank Restructuring Agency (IBRA), which was created in January 1998 to oversee bank rescues and sell assets taken over from banks and their owners. This mandate expires in 2004.[58]

IBRA now controls assets with a book value of around 550 trillion rupiah, or U.S.$ 57 billion at current exchange rates, though realisable market value is much lower. About half of IBRA's assets are bad loans taken over from banks. Most of the rest are shares in nationalised banks or in companies handed over by bank owners in lieu of their debts.[59]

IBRA's chairman is appointed by the president but the agency is under ministerial control, principally through the Financial Sector Policy Committee (FSPC), which includes the co-ordinating minister of the economy, the ministers of finance and trade and industry and the head of the National Development Planning Agency (Bappenas). The FSPC was originally created to review IBRA's decisions so as to speed them up and provide legal cover for IBRA officials who feared accusations of corruption if they took unpopular decisions.

The role of the FSPC has expanded in recent months under the steering of Co-ordinating Minister Rizal Ramli, and it increasingly takes decisions that would formerly have been left to IBRA. This is not inherently bad but it has attracted criticism from legislators who see the FSPC as a means for the Abdurrahman administration to impose its priorities on IBRA.[60] The other formal control on IBRA is an oversight board set up in mid-2000. Most of this board's members are from outside government. It is said to be dedicated and keen, though its powers to summon officials or initiate legal action are limited. IBRA relies heavily on consultants and advisers, many of them foreign, and reportedly pays U.S.$ 100 million each year on fees to investment banks.[61]

As a wealthy and influential agency, IBRA is inevitably subject to pressures from people who are either trying to get access to its wealth or seeking to stop it taking action against their interests. IBRA officials say businesspeople and other interest groups have tried to influence them, either by bribes or intimidation. It is hard to tell, however, whether corruption is widespread within IBRA. Financial crimes are almost never proved in Indonesian courts, and the anecdotal evidence is unreliable. The only senior IBRA official put on trial was Pande Lubis, the former head of the agency's bank restructuring division, who was charged in connection with the Bank Bali scandal but cleared in November 2000.

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[58] IBRA is known in Indonesian as the National Bank Recovery Agency or BPPN for short.
[59] World Bank, "Accelerating Recovery in Uncertain Times".
[60] ICG interview with Faisal Baasir of DPR Commission Nine; also *Jakarta Post*, 15 February 2001.
[61] Bloomberg, 2 March 2001. IBRA's main foreign financial adviser is Lehman Brothers, a U.S. investment bank.

Officials of IBRA and the government have been known to accuse each other privately of dubious decisions, though FSPC's veto power implies that the onus is on the government rather than IBRA to decide if a decision is in the public interest. Some decisions are clearly being influenced in ways that benefit businesspeople at the state's expense.[62] The most controversial of such cases, the Texmaco debt restructuring, is discussed later in this report.

The highly political nature of IBRA's work is reflected in the rapid turnover of its senior officials who, as in other departments, are frequently replaced without public explanation. After Abdurrahman became president in October 1999, he replaced IBRA chairman Glenn Yusuf with Cacuk Sudarijanto. Several senior officials left IBRA during Cacuk's term, and he himself was removed in November 2000 along with one deputy and replaced by Edwin Gerungan. Since Gerungan's arrival, two other deputy directors have offered their resignations.

The lack of any explanation for these changes leaves observers to draw their own conclusions. Cacuk earned a reputation as one of the more decisive IBRA chairmen, and his removal is variously ascribed to personal rivalry with Co-ordinating Minister Rizal Ramli or to his displeasing the president.[63] The name initially floated as Cacuk's replacement was a former state banker who had been removed from his previous job at IMF insistence, but his name was dropped after public criticism. The post was then given to Gerungan, a former Citibank executive with an uncontroversial record.

IBRA is aware of the suspicion it attracts. Under Cacuk it began holding regular coffee mornings and afternoon tea sessions for journalists, and it now provides far more information to the public than most state agencies. More controversially, IBRA also hired as advisers a number of Indonesian economists whose views regularly appear in the media and who might be expected to criticise its actions.[64]

There are still worrying gaps in the information IBRA provides to the public. Data is sometimes not made available or presented in such a way that its significance is hidden from anyone not well informed on IBRA issues. The result is that decisions influenced by corruption or other improper pressures could potentially remain hidden within the mass of published data. At the same time, IBRA itself faces many financial and legal uncertainties not of its own making so that it is hard for the agency to say exactly where it stands on certain issues.[65]

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[62] One IBRA official complained privately to ICG: "There's too much pressure from the stakeholders. Before, the knife was in the debtors. Now it's on us."

[63] ICG interviews with Indonesian sources. Cacuk's name was linked by some sources to Hasyim Wahid, the president's brother, who has acted as an intermediary with IBRA's corporate debtors.

[64] ICG interview with economist and politician Faisal Basri, who says he was surprised to find the money in his bank account because he had done no work for IBRA. He decided to repay it.

[65] IBRA was independently audited last year by an accounting firm which gave no opinion on its findings, an unusual practice, largely because of a number of questions that IBRA itself could not answer about the value of its assets and the extent of its liabilities. IBRA's audited accounts for 1998 and 1999 are on its website, www.bppn.go.id).

E. Asset Sales

IBRA is tasked with selling assets taken over from debtors during bank recapitalisation. Its target this year is to raise 27 trillion rupiah in cash for the budget, which may prove difficult.[66] The agency depends heavily on selling assets surrendered by a single conglomerate, the Salim group, whose in-house bank borrowed large sums from the state during 1997-98. The value of these assets has turned out to be much lower than its debts, and the government is now negotiating for more assets. This process could delay the sales of Salim companies already held by IBRA. The agency has also had difficulty forcing other bank owners to surrender assets equal to their debts: in the case of Dipasena, a shrimp farming company taken over from tycoon Syamsul Nursalim, the company was initially valued at U.S.$ 1.8 billion but its real value is now thought to be only U.S.$ 100 million.[67]

IBRA's efforts to sell assets have long been caught up in a political debate about acceptable prices. The market value of IBRA's assets has turned out to be much lower than the book value at which it acquired them. The DPR has stipulated that asset sales should recoup 70 per cent of the value at which an asset was handed over to IBRA, but analysts say a realistic rate would be nearer 30-40 per cent. This is partly because of poor market conditions and partly because of fraud by the original owners, who inflated the value of assets before handing them over to the government.

Government and parliament are reluctant to accept this lower target because it is tantamount to admitting that the state will never come close to recouping the cost of bank bailouts. This cost may in fact be rising faster than IBRA's ability to repay. Even if the agency meets its target of raising 27 trillion rupiah in cash and redeeming 10 trillion rupiah of bonds by other means, the interest due on the bank bonds this year is budgeted at 56 trillion rupiah and will cost still more if domestic interest rates continue to rise.

The pricing debate can be summarised as "sell now or sell later." The "sell-now" advocates, who include the IMF and some Indonesian economists, believe that if IBRA sells a few good companies cheaply, investors will become interested in the country again and asset prices will gradually rise. The "sell-later" advocates include parliament, which objects on nationalist grounds to a fire sale of Indonesian companies to foreigners. Corporate debtors have an interest in preventing their assets being sold cheaply to third parties, though it is usually hard to prove that they are lobbying on the issue.

The sell-now view is arguably untested. There is no dispute that Indonesia must sell assets to reduce its debts and lure back foreign capital, but cheap asset prices may not themselves be enough to attract investors deterred by broader political and legal uncertainty. The sell-later argument, however, is based on what looks like wishful thinking by legislators and businesspeople that foreign investment will return without the need for painful Indonesian concessions.

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[66] IBRA deputy chairman Slamet Sumantri, quoted in Jakarta Post, 8 January 2001, described the difficulties of meeting this target as "incredibly huge." An IBRA official involved with asset sales, Phoa Bing Han, told ICG by contrast that the target was attainable as long as political instability in Indonesia does not scare off buyers.

[67] Bloomberg, 2 March 2001.

Parliament twice blocked the sales of two nationalised banks, Bank Central Asia and Bank Niaga, because of concerns about low market prices, though it belatedly agreed in late February 2001 to let them go ahead. The delay drew protests from the IMF, the United States government and Indonesia's finance minister, Prijadi Praptosuhardjo who also argued, however, that the IMF's asset sales targets were too specific.[68].

A policy dilemma lies behind the sell-now-or-later debate. If foreign investors cannot be tempted to buy assets, then the only other potential buyers are Indonesian businesspeople. These include the same tycoons who helped create the crisis and now hope to buy back their companies at a steep discount. The government has tried to ban this practice, which would effectively mean that the tycoons retrieve their companies with most of their debts wiped clean. The difficulties of enforcing the ban, and the scarcity of alternative investors, may mean that some companies nonetheless will end up back in the hands of their original owners.

As with privatisations. IBRA's asset sales can trigger protests from workers or local people in an area where a company is located. IBRA's recent sale of palm oil plantations in Sumatra to a Malaysian company was delayed by objections from local residents, who said some of the land was seized from them in the Soeharto era, and from Indonesian palm-oil interests, who claimed the sale would give an unfair advantage to foreign competitors. The DPR took up the cause of the objectors, though the sale was eventually concluded after weeks of delay.

F. Corporate Debt Restructuring

Having taken over bad loans from banks, IBRA has the task of restructuring them so that they become viable again and can be sold back to the banking industry. This can mean spreading out the interest payments on a loan, swapping it for shares in companies owned by the debtor or, in cases where the debtor refuses to co-operate, seizing and selling the loan's collateral.

Indonesia's biggest debtors were surprised when the rupiah crashed in mid-1997. Some renegotiated their debts in good faith, while others had no idea how to repair their finances. Many simply stalled in the hope of wringing lenient terms from creditors, including IBRA and private banks. Bankers and consultants describe a deep reluctance amongst Indonesian businesspeople to accept that the unchecked growth of the Soeharto era is a thing of the past. Owners of indebted companies are generally reluctant to surrender control to creditors or sell their holdings to pay off debt. This reluctance has been assisted by government officials who maintain that indebted conglomerates can only be run by their original owners, the very people who drove them into insolvency.

The weakness of the courts has prevented creditors from using the threat of bankruptcy to force debtors to negotiate in good faith. The courts sometimes lack the technical expertise to evaluate complex transactions but the main problem is generally agreed to be the ease with which debtors can bribe judges. The

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[68] The U.S. government stance was expressed in its statement to the CGI meetings in Tokyo in October 2000, which can be found at www.worldbank.or.id. Prijadi's comment was reported on www.koridor.com, 6 February 2001.

introduction in 1998 of a revised bankruptcy law with a stronger bias towards creditors than the old law has not changed this situation.

The Abdurrahman government has taken some steps to deal with corruption in the courts. It has rotated some serving judges and recruited ad-hoc judges from among lawyers, retired judges or academics to serve in commercial cases. As a result, IBRA has won a few recent cases that it would previously have lost.[69] The new Justice Minister appointed in February 2001, Baharuddin Lopa, has promised to take firm action against corruption. But the balance is likely to remain against fair resolution of disputes without a concerted effort to tackle low salaries and poor training and impose meaningful sanctions on corrupt judges. There is now a trend in debt restructurings away from a hard-line legal approach towards one more accommodating to debtors. The attorney-general, Marzuki Darusman, says retrieval of debts from corporate debtors is being given more priority than taking them to court, given the risk that a trial will fail.[70]

IBRA has legal power to seize loan collateral from debtors under a regulation known as PP17. It allows IBRA to bypass the courts but is sometimes difficult to apply because other government departments object or because of political pressures not to use it. Were IBRA to use PP17 extensively, it would have to find and appoint large numbers of managers to run the companies taken over. The risk also remains that former owners might try to disrupt the running of these companies as a way of forcing IBRA to favour their interests. For these reasons, IBRA has often preferred to leave indebted companies under the control of managers appointed by the original owners.

Despite the legal problems, IBRA is gradually negotiating deals with its major debtors. The question then arises to what extent these deals are in the interests of the state, rather than the debtors. The IMF and the World Bank worry that too many simply allow companies to delay repayment of debts rather than forcing them to become more profitable, for instance by selling or closing loss-making subsidiaries. The fear is of another wave of defaults once companies have to start repaying debt again in a few years. [71]

IBRA faces a dilemma. The longer companies are bogged down by unresolved debts, the less quickly they can get back to business and contribute to economic growth. But the weakness of the legal system means that rapid restructurings may be difficult to arrange unless IBRA offers lenient terms to debtors at the expense of the state.

It is accepted that IBRA should be able to forgive some debts or provide fresh credit to help deserving companies get back onto their feet. But there is a risk that companies which have not acted in good faith or have poor prospects will also be helped at the state's expense. This risk is increased by the prevalence of patronage and rent seeking in Indonesia's political culture. Officials and politicians may try to arrange favourable debt deals in return for payoffs or other favours from debtors.

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[69] Comment to ICG by Robertus Bilitea of IBRA's legal division. There are now thirteen ad-hoc judges.
[70] ICG interview with Marzuki.
[71] World Bank "Accelerating Recovery in Uncertain Times". One Indonesian private banker asserted to ICG that only 10 per cent of the companies being restructured by IBRA were actually worth saving. The rest, he said, should be sold off to the highest bidder.

Indeed, there is almost universal belief in Indonesian financial circles that corruption and political interference play a part in debt restructurings, but this is hard to prove in any given case, and allegations rarely rise above rumour. The complexity of IBRA's financial models and the lack of disclosure of key information can make it hard to assess who gains or loses from a particular restructuring. Nonetheless, there are cases where it is clear that a restructuring works in the interests of a debtor and where the debtor is close to senior officials. The most controversial case is that of Texmaco.

This conglomerate ran into debt problems in late 1997 and used its influence with Soeharto to borrow another U.S.$ 1.2 billion from the state. After Abdurrahman became president, one of his ministers revealed that Texmaco had colluded with state officials to gain the loans. However, the investigation was dropped on technical grounds and the minister, Laksamana Sukardi, was later replaced for reasons that remain unclear.

Under IMF pressure, IBRA took over Texmaco's U.S.$ 2.7 billion in debts to the state and concluded a restructuring agreement in September 2000. This agreement allows Texmaco's owner, Marimutu Sinivasan, to repay the debt on very generous terms and to regain control of the group afterwards. It assumes that the loss-making conglomerate will become much bigger and more profitable than before and that IBRA can effectively monitor the agreement. Both of these assumptions are questionable.[72]

In effect, IBRA is taking a risky bet on Texmaco's future. It is possible not only that the debt will not be repaid but that the state will be tempted to pump in even more money in the hope of making it profitable. Legislators have queried Texmaco's plans to borrow another U.S.$ 60 million from a state bank, and the IMF has reportedly asked that the group receive no more state funds.[73]

President Abdurrahman has spoken in favour of Sinivasan and certain other indebted tycoons on several occasions, and many of ICG's Indonesian sources believe he is protecting Texmaco in return for support from Sinivasan.[74] Rizal Ramli, the Co-ordinating Minister for the Economy, is a former consultant to Texmaco, and Taufik Kiemas, the businessman husband of Vice-President Megawati Soekarnoputri, has also spoken in its favour. The IMF has asked the government to publish an independent review of IBRA's agreements with Texmaco and other large corporate debtors but it has so far not done so.

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[72] Memorandum of understanding between IBRA and Texmaco, interviews with Laksamana Sukardi, analyst Lin Che Wei of SG Securities in Jakarta and other sources familiar with the case. Texmaco sold valuable assets overseas during its negotiations with IBRA, whose officials only found out from the press. Dow Jones Newswires, 6 December 2000.

[73] ICG interview with Jakarta-based journalist.

[74] *Jakarta Post*, 20 October 2000.

V. THE POLITICAL CONTEXT

A. Obstacles to Reform

Indonesia is now experiencing a highly unstable form of coalition politics in which weak and divided governments struggle to create policies that are then challenged by the DPR and resisted by vested interests in the bureaucracy and big business. Add the pressures from the IMF, the press and civil society groups, and the result is policymaking which tends to be ad-hoc, short-term and poorly co-ordinated. Policy can also be distorted by corruption, which is systematic, pervasive and entrenched within the Indonesian state.[75]

President Abdurrahman's authority is challenged at almost every step by a resurgent DPR in which his loyalists are a small minority. As a result, even technical issues are politicised, such as the debate over amendment of the central bank law. This situation has been complicated by the president's lack of knowledge of economics and his propensity to listen to lobbyists who want policies amended in their own interests.[76]

Another distorting factor is the desire of politicians to gain control of state resources to build up their parties ahead of the 2004 general election, to strengthen their patronage networks or to enrich themselves.[77] The supporters of an incumbent president are inevitably in the best position to obtain state jobs, though other parties may demand that their members also be given such posts as the price of loyalty. This factor may help to explain the frequent reshuffling of officials at IBRA and other economic agencies. Abdurrahman is facing pressure to resign over two financial scandals and patronage politics could well intensify in the coming months as the president and his opponents try to bolster their support within Indonesia's political elite.

B. The Government

The current cabinet is the second of Abdurrahman's presidency. The first, a coalition of major parties, struggled to implement the LOI, with the result that the IMF cut off loans for two months in mid-2000. The parties gave Abdurrahman a free hand to pick a new cabinet in August. His new economic team, led by Co-ordinating Minister Rizal Ramli, initially made a good impression despite a controversy over the selection as finance minister of Prijadi Praptosuhardjo, an executive from the notoriously corrupt state bank sector and an old friend of the president. [78]

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[75] Corruption here is used in the accepted sense of the misuse of public office for personal gain. In Indonesia, it should be seen as part of an informal economy of payoffs and favours which underlies the formal structures of government and politics. Its influence is hard to prove because the police and the courts are themselves suspected of corruption.

[76] For a discussion of the Abdurrahman presidency, see ICG's briefing paper *Indonesia's Presidential Crisis*, 21 February 2001.

[77] A senior official at one mid-ranking party complained to ICG that far from preparing for the next election, his party's leaders were leading lavish lifestyles while the party organisation itself was short of money.

[78] Several ICG sources who have dealt with Prijadisay say that, aware of his reputation and inexperience, he consults widely and tends to follow the advice of his staff. This sometimes puts him at odds with the president.

Rizal Ramli, a former think-tank economist with an NGO background, has a reputation for hostility towards the Chinese-Indonesian tycoons who flourished under Soeharto. He is widely described as impatient with established procedures, and his reputation has been complicated by ties to Texmaco, to which he was an adviser before becoming minister.

This cabinet is now criticised for the same failings as its predecessor: lack of consistency, weak co-ordination between departments and accusations that senior figures, including the president, are moved by factional or personal aims rather than national interest. Ramli and Prijadi publicly contradict each other, and Ramli is said to have told acquaintances late last year that he expects to replace Prijadi as finance minister.[79]

The government agencies involved with financial policy include the co-ordinating ministry for the economy and the ministry of finance, as well as the National Development Planning Agency (Bappenas). Bank Indonesia and IBRA also play influential roles, though they are not represented at cabinet level, and numerous other ministries may have inputs (or objections) to particular policies.

There is some fluidity in the roles of these agencies and their relationship to each other. To give one example, the ministry for state-owned enterprises (scrapped in mid-2000) used to control the state banks until this portfolio was won by the finance ministry in a turf war in late 1999. Abdurrahman first sided with the state enterprises ministry, then changed his mind within a few days and ruled in favour of the finance ministry, which eventually absorbed its rival.

Abdurrahman has increased the already large number of bodies involved in financial policy by setting up three boards of economic and business advisers. Members of the business board included, controversially, several indebted tycoons who were negotiating with IBRA. He also created a junior ministry for economic restructuring. The current minister is Cacuk Sudarijanto, the former head of IBRA, but this ministry appears to have little power or responsibility.

Sri Mulyani Indrawati, an academic economist and former presidential advisor, says the ministries go their own way in setting policy within the broad framework of the LOI, and Ramli does not in practice have power to enforce co-ordination. Policies are made on an ad-hoc basis, and their implications are not clearly studied in advance. As a result, the government constantly revises policies after they have been announced and finds it harder to defend them against criticism.[80]

C. Parliament

Little more than a tool of the executive in the New Order, the DPR now sees its role as an aggressive inquisitor. Few policies pass it unchallenged, and officials spend increasing amounts of time justifying decisions to a legislature which sometimes seems to assume a priori that the government is trying to deceive it.

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[79] ICG confidential interview.

[80] ICG interview. Sri Mulyani resigned as a presidential advisor in mid-2000. She asserts that Abdurrahman ignored his advisers in favour of lobbyists and it was no longer possible for people with professional integrity to work for him.

The factors that influence DPR decisions include populist pressures, party rivalries, ambition, desire to reform discredited institutions and suspicion of both the New Order old guard and foreign influence. These blend in a way difficult to quantify or predict from outside. Another factor, by many accounts, is corruption of DPR members by business interests or by the government. [81]

The DPR's ability to make informed decisions suffers from members' lack of specialised knowledge. Only one in five members of Commission Nine, which deals with financial matters, have a background in business. Funds to pay for research for DPR members are also limited, yet the DPR plays an increasingly crucial role in influencing policy implementation.

D. The Legal System

Indonesia's legal system and institutions are generally conceded to be highly inefficient and susceptible to corruption. Although ignorance of the law among judges, prosecutors and police hinders the system, corruption is widely seen as more significant. In both police and judiciary, it is thought to be institutionalised, in that staff have to pay bribes to enter the profession and to be promoted, with the assumption they will recoup investments by taking bribes themselves.[82]

There are concerns about the potential for police to use their powers to help debtors or to extort money from parties involved in legal cases.[83] The Attorney-General's office is also seen as a centre of potential corruption, where staff may receive bribes for stalling investigations of senior officials or businesspeople. A new and worrying development is the government's attempts to use threats of investigation for corruption or tax violations as a political weapon against opponents or people who have offended it. Abdurrahman has directed this threat at political opponents at least twice.

VI. CONCLUSIONS

Indonesia's capacity to implement the debt-reduction measures agreed with its external creditors fully, as laid out in the Letters of Intent, is likely to remain quite limited for some time to come. This is partly because of numerous political and legal obstacles and partly because in a system where patronage plays a key role, governments may remain unable or unwilling to take on wealthy or powerful vested interests which oppose reform.

The relationship between Indonesia and the IMF, its most influential creditor, therefore, seems likely to remain volatile even if the current impasse is resolved. The IMF cannot be expected to compromise on its core principles, such as the political independence of the central bank. The high level of detail in its program

[81] Interviews with Indonesia Corruption Watch and senior government official.
[82] See ICG report Asia Report N° 13, *Indonesia: National Police Reform*, 20 February 2001.
[83] Western diplomats have raised this concern in connection with the Manulife case. Manulife, a Canadian insurance company, bought shares in a local insurance company and was then subjected to an aggressive fraud investigation by the police. Sources close to Manulife assert that the police were acting in concert with the bankrupt former owner of the local company, who wished to block the sale, and seek a payoff to drop the investigation.

may reflect lack of trust in the government's ability to meet more general targets without prompting.

Nonetheless, the many specific targets and deadlines in the program seem to offer hostages to fortune, given the likelihood the government will fail to meet at least some. The IMF's global thinking is shifting towards 'streamlined conditionality' under which the number of specific conditions in a program is reduced.[84] In the case of Indonesia, there is an argument for scaling back the degree of conditionality on those aspects of the program where what matters is attaining a broad policy target and there is a high risk of delays for reasons outside the government's immediate control.

One such area is asset sales, where the requirement for the government to sell specific banks by specific deadlines may have been too exacting, given that the policy aim is to raise a certain amount of revenue by a certain date. The need for asset sales is generally agreed, but it may be unwise to assume that a few high-profile sales will in themselves trigger a broad-based recovery of investment without increased political stability and legal certainty.

There are issues, such as the need for more transparency in IBRA's operations, where IMF aims appear to be widely supported within Indonesia. There is a contradiction, however, between the desire for rapid restructuring of corporate debt and the desire that the process be transparent and not add to the state's financial burden. Given the undue influence of debtors over the legal system and the political process, rapid restructuring will not necessarily be either transparent or in the public interest. If the priority is transparency, external lenders will have to accept that the restructuring process will take longer. In at least one important case, that of Texmaco, government officials have cited tight deadlines imposed by the IMF to justify a debt restructuring agreement that is widely considered to be flawed.

External lenders may be unwilling to consider further rescheduling, or even reduction, of Indonesia's public debt if they feel, as some clearly do, that the government has shied away for short-term political reasons from reforms that will ultimately benefit the Indonesian people. But if Indonesia's ability to repay debt weakens for reasons beyond the government's control, lenders may have to choose between granting further relief (in the form of rescheduling or other easing of terms) and seeing the government default. It has been argued both inside and outside Indonesia that under these conditions there would be a moral case for sympathetic treatment, including even forgiveness of some debt, since external lenders bear some responsibility for creating the conditions that led to Indonesia's crisis.

The problem of reducing Indonesia's public debt to more manageable levels is inseparable from the wider problems of fragmented politics, a malfunctioning legal system and a political culture dominated by rent-seeking and corruption. Lenders may have to scale back expectations about what can realistically be done in the absence of a government with durable majority support in parliament and the political will to distance itself from vested interests.

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[84] *The Economist*, 17 February 2001.

At the same time, even slow progress will have an incremental effect, however small, in reducing the risk of default and the burden of the debt on the Indonesian people, as well as easing the economic pressures which contribute to political instability and social unrest

External lenders may have little choice at the moment but to focus their lobbying on particular policies that are crucially important and/or can be made acceptable to opinion-formers within Indonesia. This does not mean the reform agenda should be reduced only to issues where there is a realistic chance of progress. It does mean, however, that there may have to be de-facto acceptance by lenders of slow progress, or no progress, on other issues.

The increased power of the DPR makes it essential that legislators be won over to the financial reform agenda espoused by external lenders. Given the strength of nationalism and the short-term outlook of many legislators, this will not be easy. One possible way in to this issue is for multilateral institutions and development agencies to build a capacity for parliamentary research that can help legislators make more informed decisions.

The single most important factor in financial reform is the supremacy of the law. This underlies all other processes from tax compliance to asset sales to the deterrence of corruption. Experience with the bankruptcy legislation suggests that purely formal reforms are not enough because corrupt elements within the legal system will find a way round them. There needs to be a holistic effort covering judicial salaries, training and effective sanctions for officials who take bribes and lawyers or parties in a case who offer them.

The government is well aware of the need to reduce corruption in the legal system and curb undue interference in the legal process by state agencies such as the police. This issue needs to be even higher on the policy agenda and to be followed through in a sustained way. The use of corruption investigations as a political weapon, a device employed by both by the government and its opponents, undermines any attempt to restore the supremacy of the law.

Indonesian governments may be tempted to win short-term advantages by allowing key decisions such as asset sales, corporate debt restructurings or appointments to state posts to be influenced by party-political imperatives or lobbying from business interests. However, such decisions inflict a long-term cost on the Indonesian people that is hard to justify in terms of the survival of any particular government.

There is a clear case for increasing public disclosure by government institutions, especially IBRA, so that the public can make informed decisions about policies. The best way to enhance transparency would be to allow independent review of all transactions above an agreed size and to publish results of that review. This would slow down asset sales and debt restructuring but delay is a price worth paying if the result is transactions more widely accepted by the public.

The government and DPR agree that some national assets should be sold to pay off debt but there is no consensus on acceptable prices or buyers. Although some asset sales have been concluded without problem, the result in other cases has been delay and controversy that damage Indonesia's image with investors.

The government should consider formulating a coordinated strategy on asset sales that covers both IBRA and the privatisation programme and involves consultations with the DPR, external lenders and investors, civil society groups, regional governments and affected communities, including workers. This strategy would ideally set realistic recovery rates, lay down procedures for sales that are consistently transparent and include a media effort to explain to Indonesians why they are necessary. Its aim would be to anticipate objections to a sale so that they could not disrupt it later. This process might be lengthy and complex and could bog down, but the record of failed or stalled asset sales is long enough to suggest the need for rethinking.

Jakarta/Brussels 13 March 2001

Glossary of Terms

Asian Development Bank (ADB) - A regional development institution

Bank Indonesia – Indonesia's central bank

Capital adequacy ratio – a measure of the ratio between a bank's capital and its assets, weighted for risk. The internationally accepted minimum is 8 per cent.

Consultative Group for Indonesia – an umbrella group of governments and organisations that make annual loans and grants to Indonesia.

Debt restructuring – When a company cannot repay its debts, creditors may restructure the debt by rescheduling repayments over a longer period, agreeing to swap the debt for shares in the company, or asking the borrower to sell assets to raise cash for debt repayment.

Dewan Perwakilan Rakyat (DPR) – Indonesia's parliament

Financial Sector Policy Committee (FSPC) – an Indonesian ministerial committee

IBRA – Indonesian Bank Restructuring Agency

IMF – International Monetary Fund

Letter of Intent (LOI) - a programme of economic reforms agreed by a country in return for IMF loans.

Liquidity credits, BLBI – Loans made by Bank Indonesia to commercial banks in 1997-98 to help them meet a wave of cash withdrawals by nervous depositors. Many of these loans were fraudulently misused by borrowers.

Paris Club – an informal mechanism for governments to reschedule their debts to other governments. The equivalent for private lenders is the London Club.

The World Bank – Officially known as the International Bank for Reconstruction and Development (IBRD)

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ICG's approach is grounded in field research. Teams of political analysts based on the ground in countries at risk of crisis, gather information from a wide range of sources, assess local conditions and produce regular analytical reports containing practical recommendations targeted at key international decision-takers.

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Special Adviser to the United Nations Secretary-General

William Shawcross
Journalist and author

Michael Sohlman
Executive Director of the Nobel Foundation

George Soros
Chairman, Open Society Institute

Pär Stenbäck
Former Minister of Foreign Affairs, Finland

Thorvald Stoltenberg
Former Minister of Foreign Affairs, Norway

William O Taylor
Chairman Emeritus, The Boston Globe

Ed van Thijn
Former Minister of Interior, The Netherlands; former Mayor of Amsterdam

Simone Veil
Former Member of the European Parliament; former Minister for Health, France

Shirley Williams
Former British Secretary of State for Education and Science; Member House of Lords

Grigory Yavlinsky
Member of the Russian Duma

Mortimer Zuckerman
Chairman and Editor-in-Chief, US News and World Report