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Reforming the IMF: Lessons from Indonesia

The IMF's weaknesses became clear to Steve Hanke when he was advising President Suharto about the adoption of a currency board in Indonesia.

On 27 April 2000, Professor Steve Hanke, Contributing Editor of *Central Banking*, testified before the US Senate Committee on Banking, Housing and Urban Affairs on "The International Monetary Fund and International Financial Institutions". A supplemental written question by Senator Mike Crapo and Hanke's 7 July 2000 response appear below.

Question: Senator Mike Crapo You served as an adviser to former Indonesian President Suharto. Despite IMF support, Indonesia remains in dire straits. What lessons did you learn about IMF lending during your time working with the Indonesian government? Did your experience contribute to your belief that the IMF cannot be reformed? If so, how?

Answer: Professor Steve Hanke: From February 1998 until President Suharto resigned in late May 1998, I acted as his adviser. Unlike members of his cabinet, I had unrestricted access to President Suharto during that period and met with him at his residence most evenings. In consequence, I had a rather unique position from which to evaluate the IMF and its relations with Indonesia. The free-fall of the Indonesian rupiah forced former President Suharto into early retirement. This was all part of a great geopolitical game in which the IMF conspired with the Clinton administration and other western powers to allow currency chaos to work its magic. Michel Camdessus, the former managing director of the IMF admitted as much, when he boasted on his retirement, "We created the conditions that obliged President Suharto to leave his job."

Steve Hanke

Weakest currency in the world

Today, President Abdurrahman Wahid faces much the same problem as did former President Suharto - the collapsing rupiah. Alas, the IMF's advice and over $10bn in credits have been unable to stabilise the rupiah. Indeed, the rupiah has been the weakest currency in the world this year, falling by almost 25% against the dollar. On 5 July, it hit a two-year low against the dollar, fuelling concerns about a rupiah free-fall and the negative knock-on effects for other currencies in the region.

This is an all too familiar story in Indonesia. When Indonesia became independent in 1949, the exchange rate was 3.8 rupiah per dollar. In 1966, a new rupiah was issued. It was equal to 1,000 old rupiah. With the current exchange rate of about 9,300 rupiah per dollar, the rupiah now equals 9.3 million 1949 rupiah. That amounts to a depreciation of almost 2.5 million times against the dollar.

As a practical matter, an unsound currency has had a devastating effect on Indonesia's standard of living, particularly on the poorest segments of the population. For example, from the end of 1996 until January 2000, the rupiah lost 66.4% of its value against the dollar, and GDP per capita fell by 35.5% in dollar terms. It goes without saying that Indonesia needs sound money. Although sound money might not be everything, everything is nothing without it.

IMF cavalry riding to the rescue

But, I am getting ahead of the story. Let's step back and put the Indonesian saga into perspective. The Thai baht collapsed on 2 July 1997, and other currencies in the region fell like dominoes shortly afterwards. The IMF cavalry came riding to the rescue with bailout money and big reform packages. Most of the IMF's reforms were of the microeconomic variety and were ill suited to remedy the life-threatening currency crises that engulfed the region. What is more, the IMF's standard macroeconomic medicine - fiscal austerity - acted like a wrecking ball on economies that were already operating under prudent fiscal regimes.

The inappropriateness of the IMF's prescription was nowhere more evident than in Indonesia. On 14 August 1997, Indonesia floated its currency, and the IMF lavished praise on the Indonesian government. Indeed, the IMF's Stanley Fischer went so far as to proclaim that the floating rupiah "will allow [Indonesia's] economy to continue its impressive economic performance of the last several years." This turned out to be the first of many IMF pronouncements that would fail to pass the test of time.

Stanley Fischer

IMF focused on cronyism

By late October 1997, the rupiah was not floating on a sea of tranquillity, and the Indonesians called in the IMF for more advice. Indonesia was facing a potential currency crisis, but the IMF insisted that it do something about rampant cronyism. This, despite the fact that for years it turned a blind eye to the World Bank's practice of pumping money into corrupt Indonesian schemes. On 1 November, the IMF assisted in the closure of 16 crony banks. This set off a financial panic. Money was pulled out of all the Indonesian banks and took flight to Singapore. The rupiah and the foreign reserves of Bank Indonesia fell further.

In an attempt to stem the tide, President Suharto signed a second IMF letter of intent, with Michel Camdessus glowering in the background. Before the ink had dried, the markets were pounding the rupiah once again. Indeed, the rupiah dropped 10% on 15 January 1998, the day the agreement was signed, and continued to plunge during the following week.

Why did the markets deliver such a resounding vote of no confidence? The second IMF agreement was little more than a large-scale structural adjustment program aimed at rooting out cronyism and opening the economy. It failed to address Indonesia's main problem, a collapsing currency. The second IMF program, like the first, did nothing more than pour fuel on a raging fire.

Demands were politically impossible

To put all this into perspective, assume that the dollar was collapsing and the IMF offered the US financial assistance, an assistance package that contained two conditions. To save the bankrupt social security system, the US would have to privatise the system in six months. And to clean up its balance sheet, the US federal government, in the same six-month period, would have to privatise its landholdings, comprising one third of the area of the US. While both of these privatisation policies would be desirable, their implementation in six months would be politically impossible. Never mind.

The magnitude of what the IMF mandated that Suharto deliver was roughly the same as the hypothetical notion presented above. And to add insult to injury, the IMF's Indonesian package failed to address Indonesia's immediate problem, the collapse of the rupiah.

Currency board proposal swept away

For a second opinion, Suharto called me in as his adviser in February, when the idea of a currency board was first broached. The rupiah rose 28% on the day people first heard about my currency proposal, infuriating both the IMF and the US government. They threatened to withhold bailout money unless Indonesia dropped the idea immediately. Caving in to this threat, Suharto eventually abandoned the currency board idea.

On 10 April 1998, a third IMF agreement was signed. It still failed to address the Indonesian currency crisis, and still more microeconomic reforms were mandated. The fuel price increases of 4 May were too much for the Indonesians to bear. Bloody riots ensued, and Suharto finally packed his bags after 32 years.

But with the IMF programmes still in place, that sad tale did not end with the fall of Suharto. Blood is still flowing in parts of Indonesia, and the rupiah is falling once again. The IMF doomed Indonesia by focusing exclusively on cronyism and corruption. Ironically, it lost Russia by turning a blind eye to these same maladies.

The specific lessons I learned from all this are:

Inability to diagnose an acute economic problem

As the above narrative indicates, the IMF proved to be incapable of diagnosing Indonesia's acute economic problem - an unsound rupiah - or prescribing a foolproof solution, a currency board. Note that ever since currency boards were first introduced in 1849, they have always produced sound money, even during civil wars.

President Suharto received a letter from Michel Camdessus, managing director of the IMF, on 11 February 1998. Mr Camdessus stated that "In order to convey to you the gist of our views on the currency boards I should tell you that this is an instrument we have supported, with success, in a few other countries and we could at a later stage consider it with favour in Indonesia. But we are of the strong view that this moment has not yet come, since for the introduction of the currency board to be successful, a number of preconditions need to be satisfied."

In consultations with the IMF in Jakarta, I attempted to obtain technical material supporting the conclusions presented in Mr Camdessus's letter. Although Prabhakar Narvekar, special adviser to the IMF director, promised to supply those materials, none were forthcoming. Indeed, the only new supporting information provided was Mr Narvekar's assertion that by obtaining a second opinion the Indonesians had "embarrassed" the IMF. Needless to say, this public pronouncement surprised me and my Indonesian colleagues.

The lesson here is clear: the IMF can be unreliable and is capable of acting in bad faith. If the IMF had acted in good faith, it would have been forced to admit that there are no preconditions for the successful implementation of a currency board. Indeed, many currency boards have been introduced when the rule of law has broken down and during periods of currency chaos. For example, less than a year before I proposed a currency board for Indonesia, the IMF had virtually forced Bulgaria, where I am President Stoyanov's adviser, to introduce a board (1 July 1997). Also, prior to the Indonesian episode, an international treaty (the Dayton Accords) mandated that Bosnia adopt a currency board. In both these cases, the economies in question were in much worse shape than was Indonesia in early 1998. Indeed, none of the so-called preconditions were met, and the Bulgarian and Bosnian currency boards worked very well, as they always have (and which they continue to do).

President Stoyanov

Lack of technical competence

Putting aside the IMF's misguided broad strategy for Indonesia, as well as its unreliability and bad faith, I was astounded by the IMF's lack of narrow technical competence. This is particularly noteworthy since some of the IMF's top staff were intimately involved in Indonesia. To support this conclusion, I will limit my remarks to only three of the many cases in which I concluded that, from a narrow technical point of view, the IMF was incompetent in Indonesia.

Earlier this year, the Indonesian government's Supreme Audit Board assisted by the accounting firm KPMG, concluded that Bank Indonesia was insolvent. Just how did Bank Indonesia rack up losses that pushed in into insolvency? I was shocked when I first reviewed Bank Indonesia's books and operations in early February 1998 and discovered that Bank Indonesia was incurring losses. I was also shocked that IMF staff were unaware of what was going on.

Abuse of lender of last resort facilities

In conducting my review of Bank Indonesia's operations, one thing caught my eye. Bank Indonesia was massively abusing its lender of last resort (LOLR) responsibilities. Engulfed in a currency crisis, Bank Indonesia had

Former Indonesian president Suharto

extended credit to the banking system at an unprecedented rate, amounting to about $37bn. In consequence, from the end of November 1997 to the end of January 1998, currency in circulation, M1 and M2 had grown by 48%, 33% and 36%, respectively. And most of this growth was a result of the banks coming up short at the end of each day and overdrafting the payments system.

Once I figured out what was going on, I reported my findings to former President Suharto. If Bank Indonesia's LOLR was not reined in, inflation would soar and the rupiah would completely collapse. I also warned that the losses implied by these LOLR activities - no collateral had been put up for the overdrafts - would eventually send Bank Indonesia into bankruptcy.

In consequence, the governor of Bank Indonesia, Sudradjat Djiwandono, was sacked in mid-February 1998. Contrary to all the press reports, that sacking had nothing to do with his views about my currency board proposal. Rather, it was the result of his massive abuse of the LOLR operations.

No idea how the payments system operated

During all of this, I was never given any indication by the IMF staff that it understood what was going on. Indeed, I became convinced that the staff could not get a grip on the real situation because it could not understand Bank Indonesia's balance sheet and had no idea of how the payments system operated.

The second display of technical incompetence occurred during a meeting at Bank Indonesia attended by both Bank Indonesia and IMF high-level people and related staff. The IMF representatives asserted that the currency board was neither desirable nor feasible. One piece of evidence that I used to show that the IMF assertion was not confirmed by the markets was rupiah interest rates in the offshore swap market. These rates fell sharply in that market on the prospect of an Indonesian currency board, indicating that buyers of rupiah-denominated assets were willing to accept lower yields than before the currency board proposal. In short, the markets indicated that the currency board would work and would be viable for at least five years, the duration of the longest-dated interest rate swaps.

Unfamiliar with the swaps market

The IMF representatives did not understand this argument because they were unfamiliar with swap markets in general and had no idea of what was going on in the rupiah swap market. This shocked Bank Indonesia staff and me.

The third example of the IMF's technical incompetence concerned its allegation that there were not enough foreign reserves to cover a currency board rupiah. This, of course, was nonsense. The reserves necessary depend on the official parity chosen when a currency board is first set up. Since Indonesia never said what this would be, how could anyone know whether the existing reserves would be adequate?

The possibility of an initial reserve deficiency is not an argument against currency boards, however. The problem can in fact be handled in a number of ways. Indeed, some currency boards have been successfully established without any cover of their outstanding monetary liabilities. The most notable case was Argentina. When it established a currency board in 1902 linking the peso to gold, 293 million pesos were outstanding, but Argentina had virtually no gold reserves. As a solution, Argentina chose to require no reserve backing for the outstanding fiat issue of pesos. But it required 100% reserve cover for any new pesos issued beyond the initial 293 million. Confidence was so enhanced by the currency board system that the demand for pesos grew rapidly and convertibility was never threatened.

For politically unstable and crisis-ridden Indonesia of 1998, the Argentine solution of 1902 was not an option. The other obvious solution would have been for the IMF to make a long-term loan of enough reserve currency to the new currency board, as it did in Bulgaria in 1997. But the bitter opposition of the IMF and the US Treasury to the Indonesian proposal made this alternative impossible for the Suharto regime.

The "parallel currency" approach

As another alternative, Indonesia could have resolved any initial reserve deficiency by implementing a "parallel currency" approach that was similar in spirit to the 1902 Argentine solution. The existing stock of rupiahs would have remained on the books of Bank Indonesia and in the pockets of Indonesia, but no more old rupiah ("OIR") base money would be created. Using available reserves, Indonesia would then have established a currency board that issues a new rupiah ("NIR") back 100% by foreign currency reserves. The NIR would trade at a fixed rate to the dollar and would float freely against the OIR. Over time as reserve assets are built up, the OIR would eventually be replaced by the fully backed NIR. I actually proposed such a parallel currency system on 27 March 1998. It should have ended all debate about adequate reserves, but alas, thanks to the IMF's incompetence, it did not.

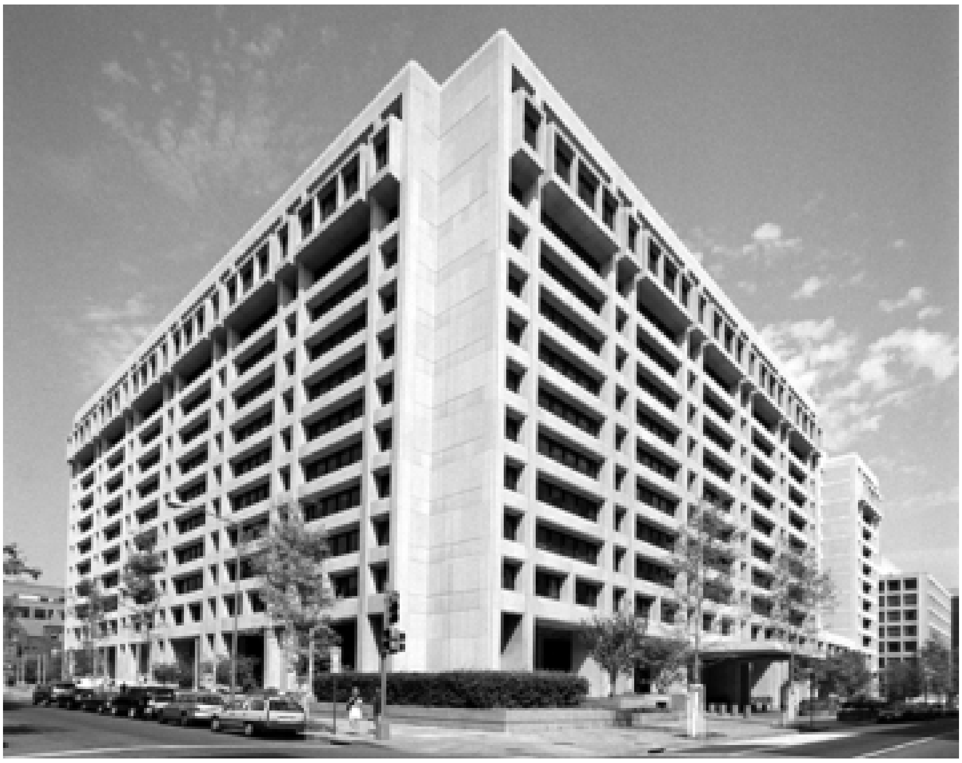
The IMF cannot be reformed

My experience in Indonesia did contribute to my belief that the IMF cannot be reformed. However, before I became President Suharto's adviser, I had already come to the conclusion that constructive IMF reforms would be very difficult to formulate and implement. The agenda of the IMF is driven by crises. With each new crisis, the ever-opportunistic IMF has been able to expand its scale and scope. Crises will continue to drive the IMF's agenda.

The hydra grows another head

One vignette will put my scepticism into perspective. With the election of Ronald Reagan in 1980, it looked as if the glory days of the IMF might come to an end. The Reagan administration favoured restrictions on IMF lending. But the Mexican debt crisis changed all that. The hydra grew another head: IMF lending was necessary for "preventing debt crises and bank failures." Ronald Reagan himself proclaimed that he had personally lobbied 400 out of 435 Congressmen to obtain approval for a US quota increase for the IMF, and from 1980 to 1985 IMF lending increased by 27% in real terms. Of course, most of this lending was little more than a bailout of foreign banks that were overexposed in Latin America.

In consequence, it will be difficult for the US Congress to come up with an IMF reform package that is strong enough to override a crisis-induced IMF agenda to expand its scale and scope. This is particularly the case when one considers that the US does not, on its own, have the voting power to force change at the IMF.



The IMF

The only strategy that will rein in the IMF is one that reduces the frequency and magnitude of crises. Such a strategy would dry up the IMF's client pool and the demand for the IMF's services. The most promising approach to eliminate crises is the abolition of central banks and national currencies in emerging market countries.

Put simply, to avoid unsound money and currency crises, emerging market countries must abolish their central banks and national currencies. That would put currency crises in the dust bin. For example, if Indonesia unilaterally adopted the dollar, it would no longer have an exchange rate vis-à-vis the dollar. So how could it have a currency crisis?

Dollarisation as a solution

Would this be radical? Not really. Thirty-one political entities use foreign currencies as legal tender. In the last year alone, Kosovo, Montenegro, East Timor and Ecuador have replaced their national currencies with either the DM or the dollar. Moreover, on 13 July 2000, the US Senate Banking Committee debated a "dollarisation" bill (S. 2101). If the bill becomes law, the US would share the seignorage generated by producing dollars with countries that replaced their national currencies with the dollar. This would even further enhance the attractiveness of dollarisation for countries that qualified. Furthermore, if dollarisation catches on, it will, over time, dramatically reduce the need for the IMF. In consequence, I believe that S. 2101 presently provides the most realistic way to rein in the IMF. □