Beyond Crony Capitalism: From Banking Crisis to Financial Crisis in Indonesia

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In mid 1998, a World Bank study grimly noted that “Indonesia is in deep economic crisis. A country that achieved decades of rapid growth, stability, and poverty reduction is now near economic collapse . . . no country in recent history, let alone one the size of Indonesia, has ever suffered such a dramatic reversal of fortune.” There is bitter irony in Indonesia’s fall from grace. Long hailed as a model of successful economic development, it was widely predicted to escape the fate of Thailand.¹ Between June and August 1997, as Thailand’s economy unraveled and the virulent Asian flu sent shock waves through the region, the Indonesian economy remained relatively stable — a seemingly veritable rock in the stormy sea. Even the World Bank (1997) remained upbeat about the short-term outlook, believing that a modest widening of the intervention band (from 8 per cent to 12 per cent) within which the Rupiah was allowed to be traded would be sufficient to ward off contagion. The Indonesian government, which received much praise for its swift and decisive response to the crisis, went to great lengths to assure jittery investors “that Indonesia was not Thailand.” Then the unthinkable happened. Indonesia suddenly succumbed to the contagion and, measured by the magnitude of currency depreciation and contraction of economic activity, it emerged as the most serious casualty of Asia’s financial crisis.²

What happened? Why did Indonesia (and other high-performing Asian economies) collapse like hollow dominoes? In the numerous post-mortems that have followed, analysts have identified a number of related factors behind the region’s dramatic reversal of fortune. In the case of Indonesia, the variable that soon acquired particular salience was ‘crony capitalism’. Initially popularized by The Economist (1998), the term quickly took a life of its own. Soon thereafter, the distinguished MIT economist, Paul Krugman (1998) would argue that crony capitalism lay at the root of Indonesia’s, indeed, East Asia’s, financial woes.

Krugman’s emphasis on crony capitalism, while not without merit, is too simplistic. After all, korupsi, kolusi dan nepotisme (corruption, collusion and nepotism) has long been pervasive in Indonesia (King 2000; Schwarz 2000). It was hardly an obstacle when Indonesia notched up impressive economic
growth rates for some three decades prior to the crisis. Back then, crony capitalism was politely referred to as the ‘government-private sector nexus’ and viewed as a unique feature of East Asian ‘developmental states’, and even a necessary prerequisite for development. Rather, this paper argues that a more nuanced understanding of Indonesia’s economic crisis can be gained by differentiating between the ‘sources of vulnerability’ and the ‘precipitating’ factors. A careful review of the events leading to the crisis show that both these factors converged during the critical period between late August 1997 and March 1998 — and practically everything that could go wrong did over these months. The greatest source of vulnerability, indeed, the fundamental weakness lay in Indonesia’s over-guaranteed but under-capitalized and under-regulated banking sector. The precipitating factors were the contagion, but more importantly, poor macroeconomic management by the Suharto regime. To a lesser extent, the International Monetary Fund (IMF) exacerbated the crisis.

Sources of Vulnerability

With such an enviable record of development and seemingly sound economic fundamentals, what went wrong? The roots of the crisis can be traced back to the mid 1980s, when Indonesia embarked on an ambitious economic reform programme. The reforms were designed to diversify the economy in order to reduce its dependence on the oil sector, encourage the development of a competitive non-oil export-oriented industrial base that would absorb the rapidly growing labour force, and expand the role of the private sector, including foreign capital (Nasution 2001; Prawiro 1998). Key elements of the reform measures between 1985 and 1996 included: (a) gradual liberalization of direct investment inflows to promote non-oil exports and economic diversification; (b) maintenance of a competitive exchange rate; (c) trade liberalization and tariff reform; (d) improvements in monetary management; (e) financial sector reform through liberalization of external inflows; and (f) the promotion of competition in the banking sector (Rosul 1998). For example, in October 1988, deregulation removed most of the entry barriers. New banks, whether joint ventures or domestic, could be set up with capital requirements of Rp. 50 and Rp. 10 billion. Regulations on opening new branches were substantially relaxed and reserve requirements were drastically reduced (Bhattacharya and Pangestu 1997, 417). Also, (h) encouraging the growth of the capital market by extending the role of the market in raising funds for investments and lengthening the maturity of money market instruments. Further, in 1989, the authorities liberalized portfolio capital inflows by eliminating quantitative limits on banks’ borrowing from non-residents. Foreigners were allowed to own up to 49 per cent of the shares issued by listed domestic companies